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National Electricity Market Campaign

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Submission to the AER

Powerlink Revenue Determination

Draft Determination

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Total Environment Centre's National Electricity Market Campaign

Established in 1972 by pioneers of the Australian environmental movement, Total Environment Centre (TEC) is a veteran of more than 100 successful campaigns. For the last forty years we have been working to protect this country´s natural and urban environments: flagging the issues, driving debate, supporting community activism and pushing for better environmental policy and practice.

TEC has been involved in National Electricity Market (NEM) advocacy for eight years, arguing for greater utilisation of energy efficiency and demand side participation to meet Australia's electricity needs.

Introduction

Total Environment Centre welcomes the opportunity to comment on the AER's Draft Determination of Powerlink's Revenue Proposal for 2013-2017 (the Proposal).

As we stated in our initial submission to the revenue cap process, Powerlink's Proposal is an excellent example of how Network Service Providers (NSPs) 'game the system' during revenue determinations. That is, they manipulate the revenue proposal process in order to increase their expenditure, and therefore profits, beyond necessary and efficient levels. Like many such revenue proposals, Powerlink's Proposal is characterised by excessive complication and the use of novel ways of presenting key data in order to convince the Australian Energy Regulator (AER) and consumers that it is supplying electricity as efficiently as possible, and that the massive revenue increases it proposes are justified.

Total Environment Centre is pleased that the AER has identified that Powerlink's proposal is unreasonable, and that the AER is currently proposing significant changes to the National Electricity Rules (the Rules) that aim to curb the gold plating that is currently common practice amongst NSPs.

However, Total Environment Centre is of the opinion that the AER must also more effectively use its existing powers to ensure that Powerlink's profligate increases in capital and operating expenditure (capex and opex) are not 'locked in' until the next regulatory period (2017-2018 — 2021-2022).

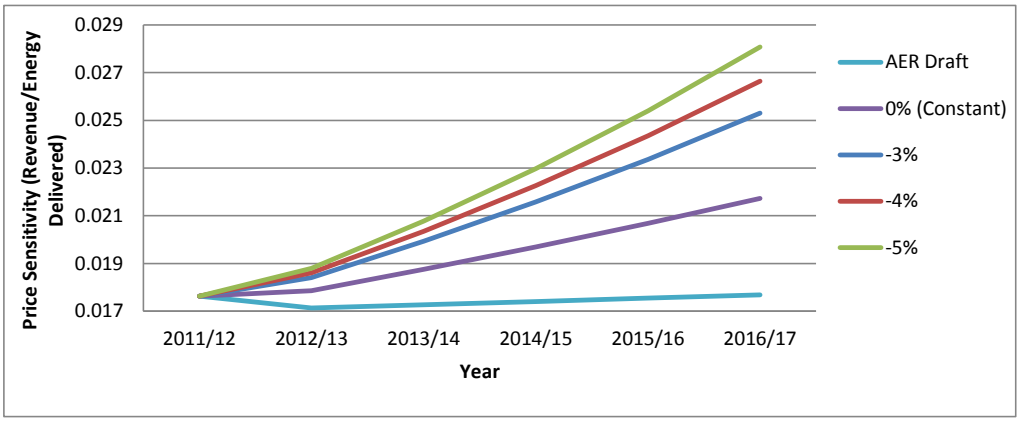
In this submission, we outline our concerns with the Draft Determination and urge the AER to make further cuts to Powerlink's excessive expenditure proposals.

Incorrect Calculation of Price Impacts

The most pressing issue is that the AER appears to have made a significant error in its calculation of the price impacts of its Draft Determination. The Draft Determination only fractionally adjusts Powerlink's energy delivered forecast, simply applying the same proportional reduction that has been applied to the peak demand projections, rather than applying reductions appropriate for overall energy delivered.[1] This incorrectly assumes that the energy delivered will be increasing by around 4-5% per annum, when it will actually be reducing.[2] We submit that Powerlink's energy delivered will likely decrease by around 3-5% per annum, as detailed below.

Even if it were to be assumed that the annual energy delivered will remain constant, the price impact would be in line with the revenue increase (i.e. an increase of around 7% per annum). If the projected downward trend in energy delivered is to continue, as seems likely, the price increase will likely be around 10% per annum, and Powerlink will be receiving much greater revenue for a much lower amount of energy delivered. This price sensitivity is expressed in the following chart, which illustrates how Powerlink will earn much greater returns on each unit of energy delivered as demand reduces.

Price Sensitivity under Differing Energy Delivered Scenarios[3]



[1] This incorrect assumption is confined to a footnote on page 277 of the Draft Determination, which states: "The AER's adjustments to the energy delivered forecasts are made based on the same proportion of the AER's adjustments to Powerlink's peak demand".

[2] As outlined in EMCa's report to the AER.

[3] Powerlink's most recently published figure for energy delivered was 46,216 GW-h. Powerlink, *Annual Report* (2011).

Total Environment Centre is concerned that the AER's 'headline figure' of a 0.8% average annual increase, quoted in the Draft Determination, does not reflect the true impact of this Draft Determination, as suggested by the figures above. This figure suggests, particularly to consumers, that the AER has taken a tough line with Powerlink and successfully constrained price increases, when the reality is that, even with the AER's reductions, Powerlink will be benefiting from a considerable increase in profits to the benefit of their owners and the detriment of consumers.

Given the foregoing Total Environment Centre therefore requests that the AER urgently attends to this error.

The Adequacy of the Reductions Proposed in the Draft Determination

The reduction of revenue by 23% over the duration of the 5 year regulatory period initially appears significant. However, this reduction must be considered in the context of Powerlink´s original claim. Powerlink's initial Proposal was undoubtedly an ambit claim: a manifestly excessive proposal made in the expectation that the AER would reduce the revenue cap. In this context, a 23% reduction seems wholly inadequate.

Total Environment Centre acknowledges that the AER is somewhat constrained by the Rules in this respect; however, we are of the opinion that the 23% reduction proposed is not sufficient to bring Powerlink's revenue proposal within a reasonable range. The Draft Determination will result in an increase of Powerlink´s average annual revenue of around 40%, compared to the current regulatory period, and an increase in prices of around 10% per annum.

Demand Growth Projections

In our submission to the Proposal, Total Environment Centre strongly criticised Powerlink's demand projections. The regulatory process has shown this criticism to be correct, with an almost universal recognition that Powerlink has consistently made predictions for load growth that are well out of step with reality.

We agree with the AER that various issues with Powerlink's proposal "consistently lead to an upward bias in Powerlink's demand forecasts". That Powerlink could have deferred at least $700 million had it correctly forecasted demand is illustrative of how excessive Powerlink's forecasts are.

EMCa comprehensively refuted Powerlink's peak demand and overall growth projections. Key findings by EMCa were that:

- peak demand growth is likely to be around 3% per annum rather than Powerlink's projected 4%;[4] and
- the electricity delivered (MW-h) by Powerlink will actually decline, rather than increase at around 6% each year as suggested by Powerlink. This comes as no surprise given every stakeholder submission to this process believed this to be the case.

The AER has also rightly identified a range of questionable aspects of Powerlink's projections, in particular the use of incorrect assumptions and inputs such as electricity prices and population assumptions and issues with the temperature correction method used by Powerlink.

In its Proposal, Powerlink cites forecasts contained in the Electricity Statement of Opportunities (ESOO), published by the Australian Energy Market Operator. The clear tenor of Powerlink's Proposal was that the ESOO is an unbiased projection of demand made by the AEMO. In its submission to the AER, the AEMO noted that it does not make such projections, and that it is Powerlink itself that supplies these figures. The AEMO further states that Powerlink's energy and demand projections have been consistently high. AEMO's analysis suggests Queensland's demand could be between 240-620MW lower than Powerlink's forecasts.

In short, EMCa concludes:

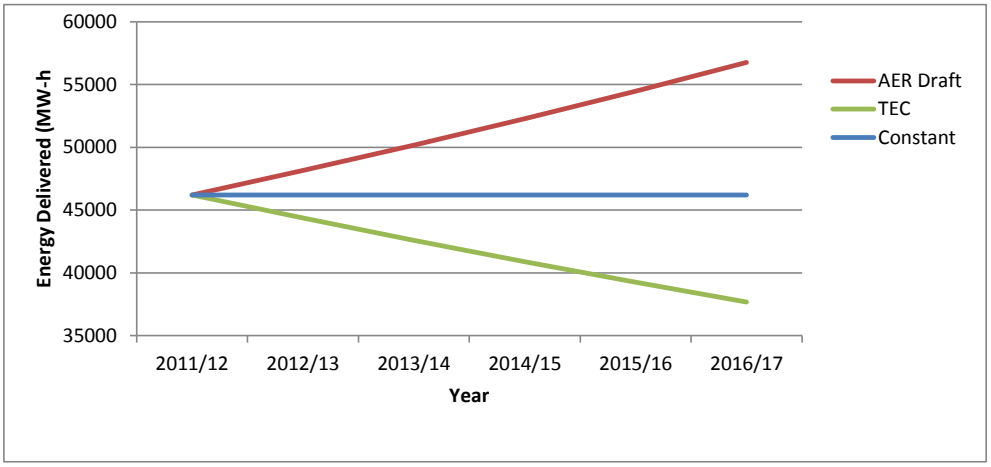
> Each path has considerably over-estimated the eventual actual and corrected peak demands. This pattern appears to continue in Powerlink's revenue proposal. Despite the pattern of over-forecasting, EMCa found no evidence Powerlink systematically reviews the accuracy of its demand forecasts.

Reducing Demand

Total Environment Centre submits that, contrary to Powerlink's excessive projections, and contrary to the inadequate reductions proposed by the AER, demand will reduce by around 4% per year over the next regulatory period. A comparison of our projections and those of the AER are represented in the graph below. The constant energy delivered projection provides a reference point.

[4] This is a considerable change in the context of peak demand, which has generally been growing at a much faster rate than overall electricity demand.

Comparison of Energy Delivered Projections[5]



Capex

Total Environment Centre stated in our previous submission that Powerlink's capex proposal was far too high. We are pleased that the consultants engaged by the AER agree and that the AER has proposed a reduction in Powerlink's capex by $1,128m.[6]

Total Environment Centre notes that key reductions include:

- $301m for 500kV upgrades, which reflects poor justification provided for these upgrades; and
- $554m for load-driven augmentation projects, which reflects that Powerlink's peak demand growth was grossly overestimated.

These reductions reduce Powerlink's total average annual capex to a level similar to that of the current regulatory period. We submit that the AER has focused solely on Powerlink's proposed load-driven capex and has simply 'rubber stamped' non-load-driven capex (amounting to $1,390 million). Thus we submit that Powerlink's capex would be much lower in non-load-driven capex was properly analysed. Again, given the 'blue sky' nature of Powerlink's initial proposal, it is submitted that the AER should reduce Powerlink's proposed non-load-driven capex.

The submissions raised concerns with a number of aspects of Powerlink's non-load-driven capex, most notably Powerlink's excessive replacement network expenditure and non-network

[5] Powerlink's most recently published figure for energy delivered was 46,216 GW-h. Powerlink, *Annual Report* (2011).

[6] From $3,488m to $2,360m.

expenditure. Total Environment Centre does not believe that the AER has subjected these aspects of Powerlink's Proposal to sufficient scrutiny.

While Total Environment Centre again acknowledges that the Rules are weighted heavily in favour of NSPs in this regard, given that NSPs spend countless hours and funds on revenue proposals while the AER is severely time- and resource-constrained, it is not acceptable for the AER to not simply no subject important aspects of revenue proposals to analysis.

Weighted Average Cost of Capital (WACC)

The Draft Determination states that the reduction in Powerlink's WACC is the "most significant driver of the AER's lower revenue allowance". We applaud the AER for significantly reducing the WACC. However, Total Environment Centre considers that Powerlink's WACC proposal, particularly the proposed debt premium and nominal risk free rate elements, was quite clearly an ambit claim and should therefore have been reduced further.

In particular we wish to reiterate some of the points made by 'the Group' in their 14th December presentation:

- Powerlink operates at 66% gearing; the AER allows 60%. This provides a windfall to Powerlink as the allowed return on equity is higher than the return on debt.
- The recent trend in AER decisions has been to reduce the market risk premium to 6%. The same reduction should be made in this case.
- Powerlink's current cost of debt is currently only 6%, whereas the cost of debt proposed by the AER is 7.51%. The cost of debt proposed by Powerlink is 8.16%.
- Powerlink's debt is obtained from an already-secured debt facility, meaning there are no debt raising costs, yet the Draft Determination allows $18.9 million for debt raising costs.

Opex

Total Environment Centre is surprised to see such a low reduction, only 8%, to Powerlink's proposed opex. This reduction allows for a 30% increase in its average annual opex compared to the current regulatory period, and around 220% compared to the previous regulatory period. This truly is a staggering increase and is a major flaw in the Draft Determination.

An 8% reduction evidences the fact that the AER has only conducted a shallow analysis of Powerlink's opex and has only scratched the surface of Powerlink's wastefulness and inefficiency. To take one example, a number of submissions to the AER suggested that Powerlink has underestimated the scale economies that can be leveraged by a monopoly infrastructure business, yet the AER has simply taken Powerlink's 'economies of scale' factors at face value and accepted their estimates. If the AER's determination is to succeed in increasing

efficiency, it must be much stricter with its opex allowances and more accurately assess the economies of scale that are available to monopoly businesses like Powerlink.

As discussed in our previous submission, and others, Powerlink does not have a reputation for efficiency, and this manifestly excessive opex proposal evidences this. The AER must make greater efforts to ensure that businesses such as Powerlink are not permitted to institutionalise wastefulness at the expense of consumers.

Powerlink's Response

We note that in Powerlink's response to the AER's Draft Determination, Powerlink has requested $5,004 million; an increase of $427 million on the AER's indicated figure. There are a number of deficiencies in Powerlink's response, most prominently:

- failure to discuss or revise the energy delivered assumptions. Powerlink continues to assert that their energy delivered will continue to increase by an average of 5.5% per annum, in stark contrast to the facts; and
- Powerlink's revised revenue proposal has deliberately avoided any discussion of the 'inconvenient truth' of their declining energy delivered. Again, in stark contrast to the facts, when calculating its price impacts (Table 1.4, page 12) Powerlink is still assuming that the energy delivered by its network will increase by an average of 5.5% per annum over the next regulatory period.

Powerlink's revised proposal mounts a 30 page challenge to the AER's revised forecast. This demonstrates the voracity with which Powerlink intends to maintain its excessive and wasteful expenditure. The AER must respond decisively in order to ensure that transmission prices in Powerlink's service area do not increase by the 10% per annum that is currently proposed.

Recommendations

In summary, Total Environment Centre requests that the AER further analyses and reduces Powerlink's excessive expenditure proposal. In particular we recommend:

1. Correcting, as a matter of priority, the erroneous application of the same proportional reduction for both peak demand and overall demand projections.
2. Reducing energy delivered forecasts by 4% per annum.
3. Reassessing and reducing Powerlink's non-load-driven capex.
4. Further analysing the WACC and, in particular, making the following changes:
    - making the gearing parameter more reflective of Powerlink's gearing situation;
    - bringing the market risk premium in line with the recent trend;
    - reducing the excessive cost of debt allowance; and
    - altering the debt raising cost parameter to reflect the fact that Powerlink has already secured its debt facility.
5. Drastically reducing the 30% allowed increase in Powerlink's opex.

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