United Energy

Regulatory Proposal 2011 - 2015

Agenda

- Introduction and Background
- Benchmarking of Outcomes
- Contracting Arrangements
- Cost of Capital
- Capital Expenditure Requirements
- Concluding Remarks

Introduction & background

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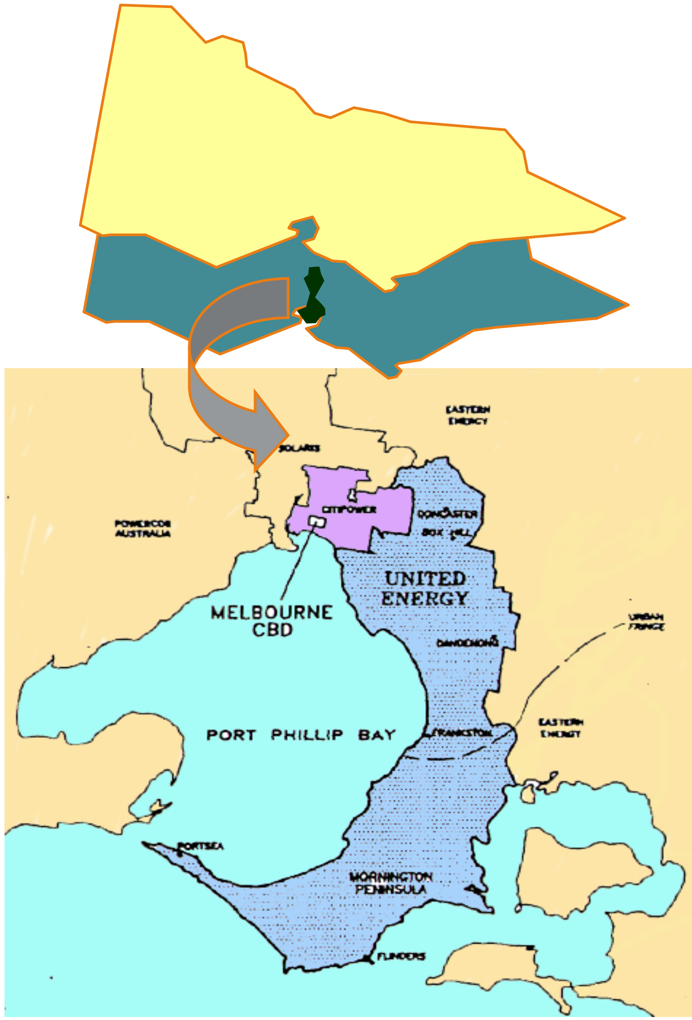
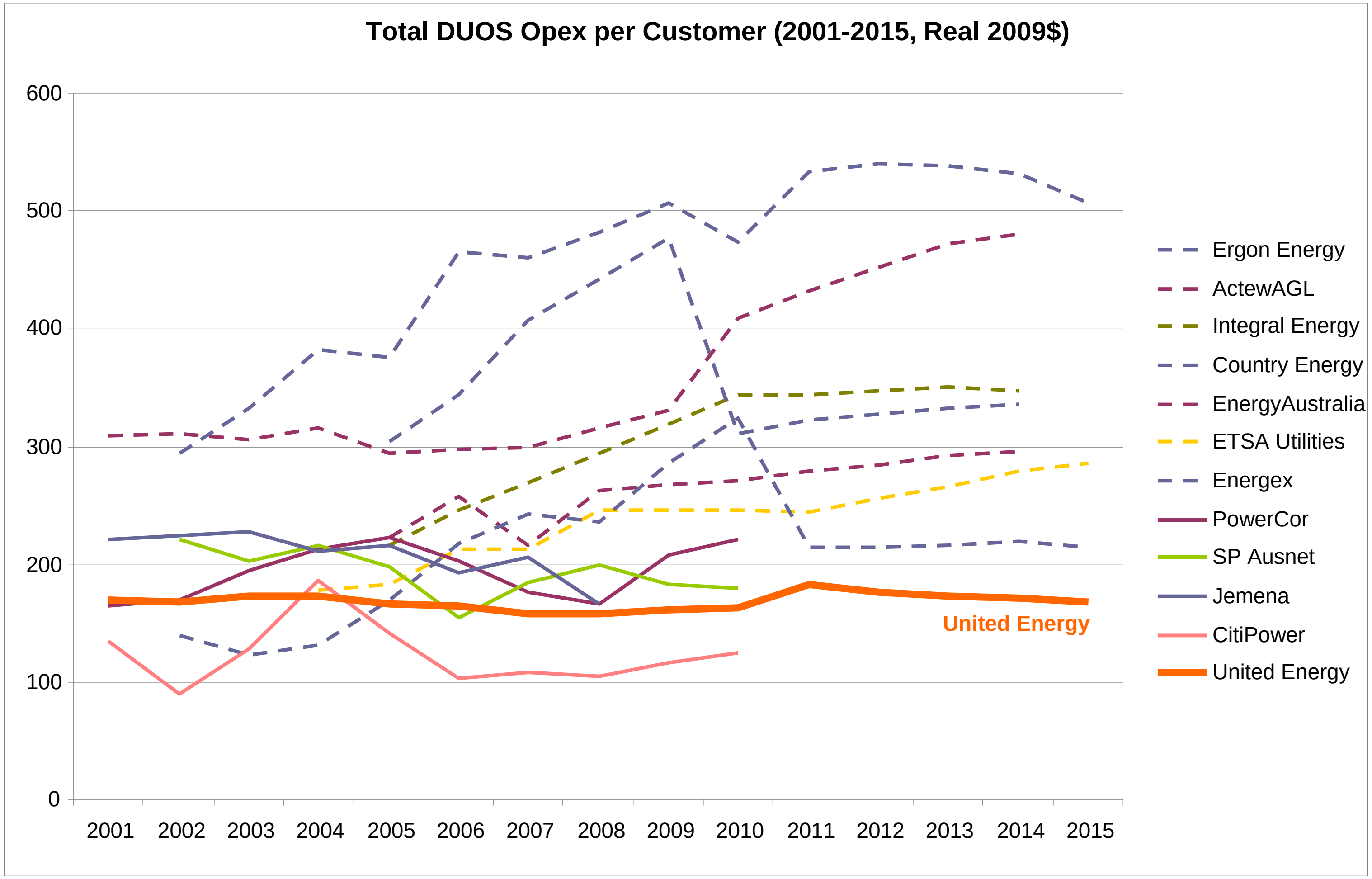
Distribution

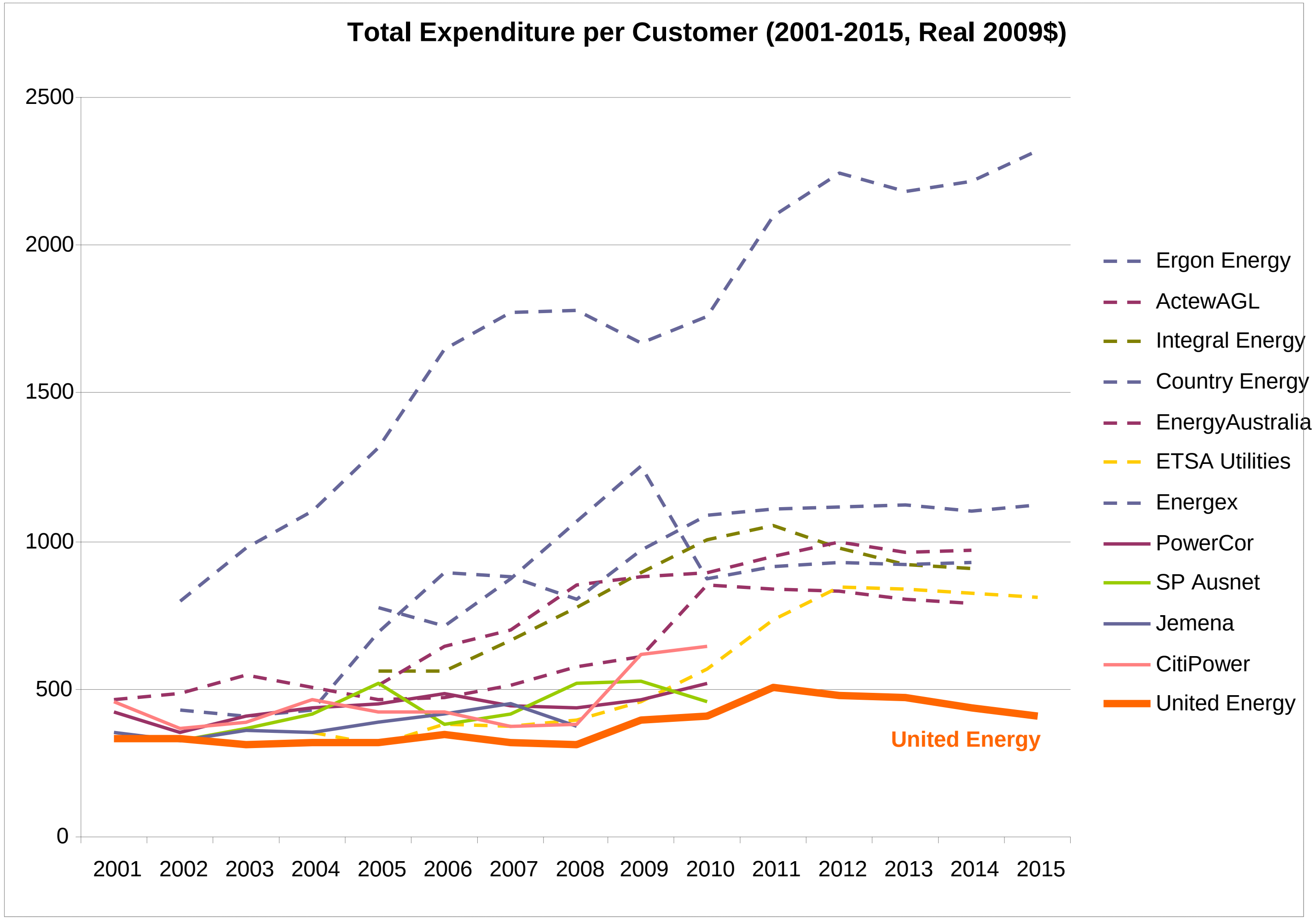


- **12,000 km of lines**
- **Over 630,000 customers**
- **430 customers/square km**
- **1,472 sq km**
- **25% of Victoria's population, 6% of Australia's population**
- **Privately owned & operated since 1995**
- **Owed 66% by DUET and 34% by SPIAA**

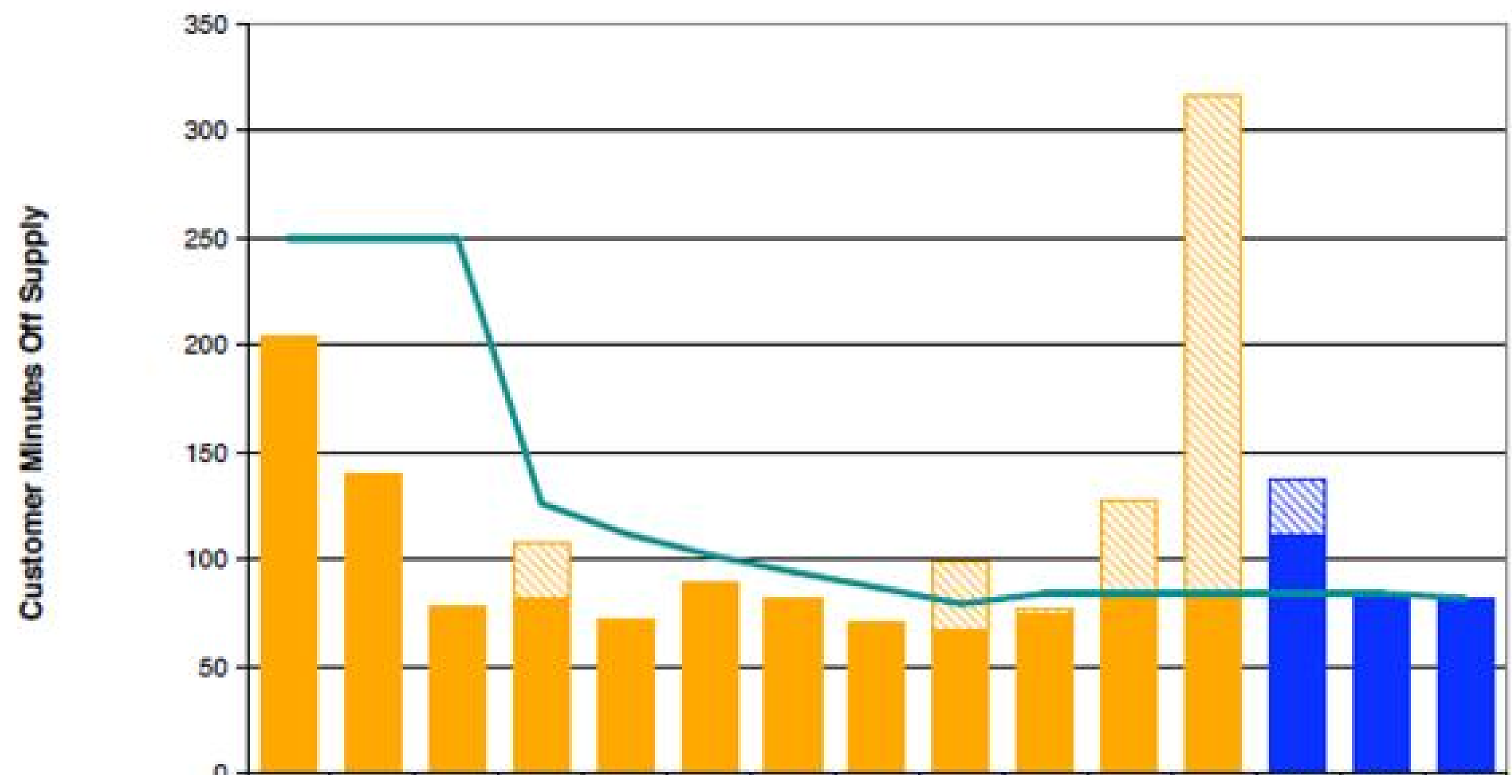
Benchmarking data - Opex



Benchmarking data – total expenditure



Reliability Performance



	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 Forecast	2010 Forecast	2011-15 Forecast
Excluded Events				25					31	1	44	233	26		
United Energy	205	139	78	82	72	89	82	70	67	75	84	84	111	84	82
Reg. SAIDI target	250	250	250	126	112	102	94	87	79	84	84	84	84	84	82

Contracting Arrangements

- **The Vic DB's efficiency improvements since privatisation have been driven by aggressive restructuring and outsourcing:**
  - UED has lead this drive
  - UED's 2003 restructure took outsourcing to the next level
  - But met with disapproval of the regulator – related party issues
  - It is noted that current contracting arrangement locked in a fixed opex fee during a time on increasing costs, industry wide
- **UED has now started to processes to restructure its contracting arrangements to:**
  - Give greater flexibility to cope with the significant changes facing electricity distributors in the future
  - Respond to regulatory concerns
  - Build on the efficiencies achieved to date
  - Lock in market based best practice pricing for the coming 5 years

  Part of UED's business transformation project

Business Transformation Project

- **Brings core functions in-house – *(where now outsourced*)**
  - e.g. asset management, stakeholder communications,
- **Main operations functions still outsourced**
  - Contract scope requires contractor to help transform the business
  - Tender process has accessed “best of breed” contractors
  - New structure to progressively reduce reliance on a single contractor
- **Best practice contract terms**
  - Alliance style contract
  - Incentives relate to items important to consumers: reliability, customer service, efficiency, value for money
- **EDPR costs forecasts**
  - Based on output from transformation project – including tender prices
  - Delivers reducing cost structure over the 5 years

Tendering Process

- **Three basic stages**
  - Expression on interest (over 60 respondents)
  - Request for Proposal (4 consortia invited)
  - Target Cost establishment (best 2 consortia invited)
- **Tender process now complete**
  - Highly competitive process - Winner now selected
  - New contract takes effect 2011 (at end of current contract with Jemena)
- **Note that Jemena has a "right to match" - *If Jemena do match:***
  - They must deliver to the market determined price, contract terms, and service quality requirements
  - Winning field services tenderer to have sub-contract for ½ UED area
- **Independent reviews**
  - Dench McLean - probity audit
  - KPMG have reviewed development of EDPR costs forecasts
    - Reviewing forecasting process and roll in of tender prices
    - They have concluded that outcomes are efficient and that function have not been duplicated

Cost of Capital

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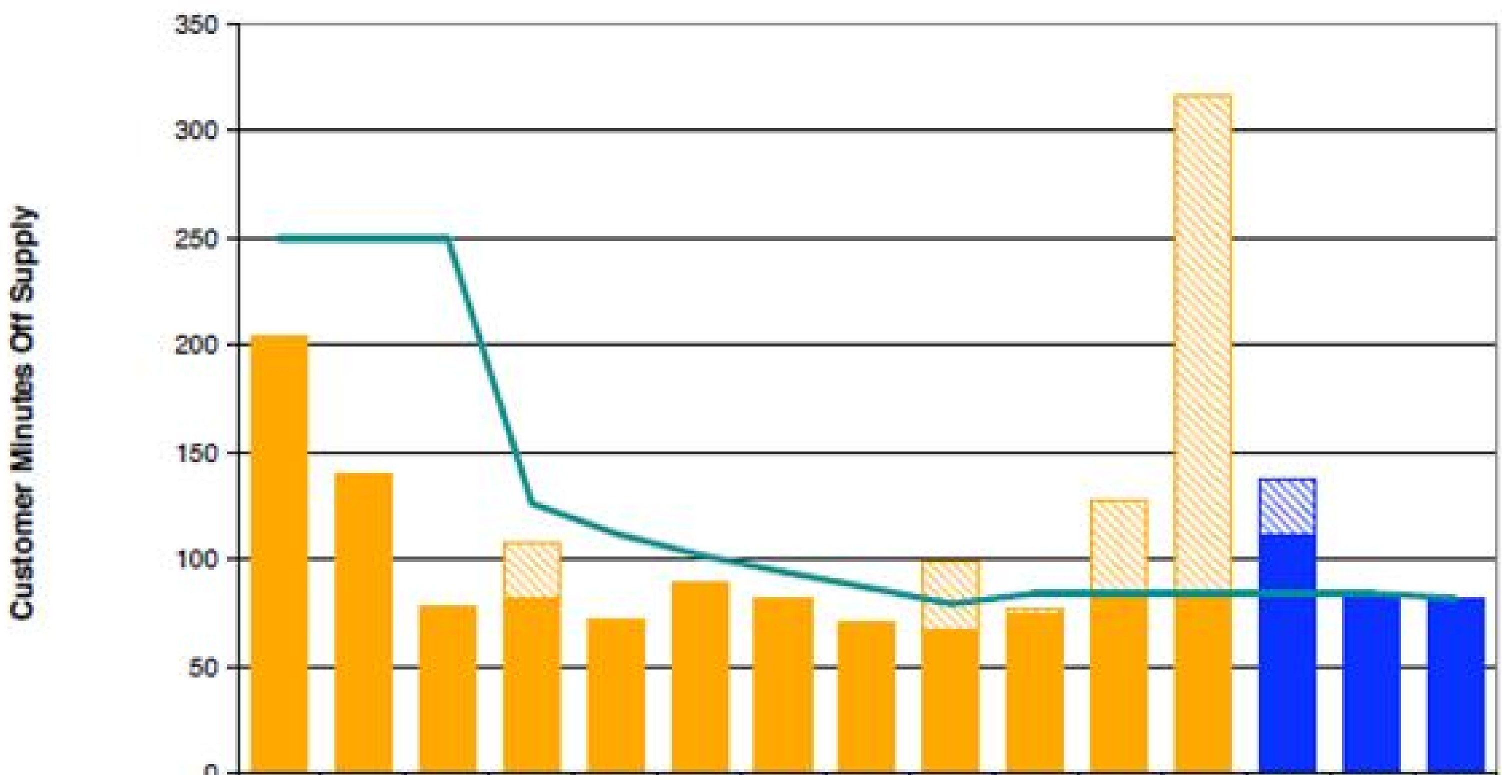
- **The single biggest reason for UED's price rise**
  - Interest rates have increased as is the cost of equity and the cost of borrowing
- **At the time of the SORI the GFC had just hit – outlook very unclear**
  - The AER recognised the need to increase MRP
  - But impact very unclear noting they needed to look out 10 years
  - Adopted a nominal 0.5% increase in MRP (to 6.5%)
- **Setting the MRP at this EDPR is a very different task**
  - GFC better understood (but still some challenges)
  - Relevant time period is next 5 years (not 10 years)
  - MRPs of 12% observed in the market
  - The global financial crisis is not over and MRP is still relatively high
- **Expert advice from Officer and Bishop**
  - Forecasts 8% MRP over 2010-2015
  - Parallels to high continuing risk premia in debt market
- **UED needs to raise new equity to fund capex program**
  - WACC must support this

Capital Expenditure

- UED's capital expenditure benchmark for the 2006 – 2010 period is approximately $600m
- UED is forecasting to spend the entire amount (this is 30% higher than the 2001 – 2005 period)
- UED has demonstrated that it is capable of managing an increasing spend profile
- UED is now forecasting a capital expenditure requirement of $910m for the 2011 – 2015 period
- This has been independently verified by AECOM (network) and Deloitte (IT) as being a prudent investment

Reliability Performance



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Major Drivers of Capital Investment Increase

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- **Ageing Asset Profile**
  - Network that "began" construction in the 1950's and 1960's
  - Network expansion continued into the 1970's
  - Comprehensive and wide-ranging asset life extension programs were developed and implemented in the 1980's and 1990's
  - Generally life extension provided us with a 10 to 20 year replacement deferment opportunity

Major Drivers of Capital Investment Increase

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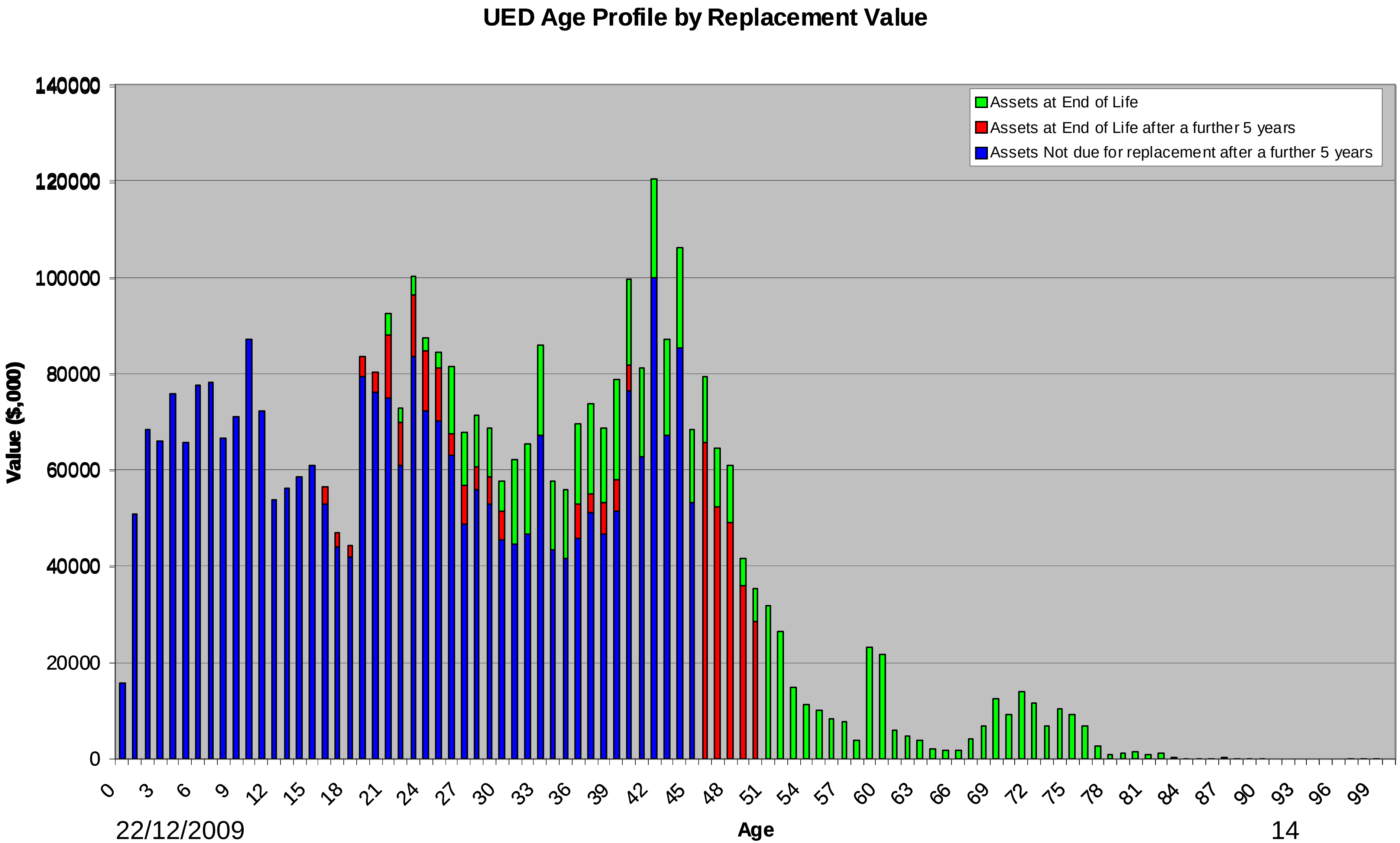

Major Drivers of Capital Investment Increase

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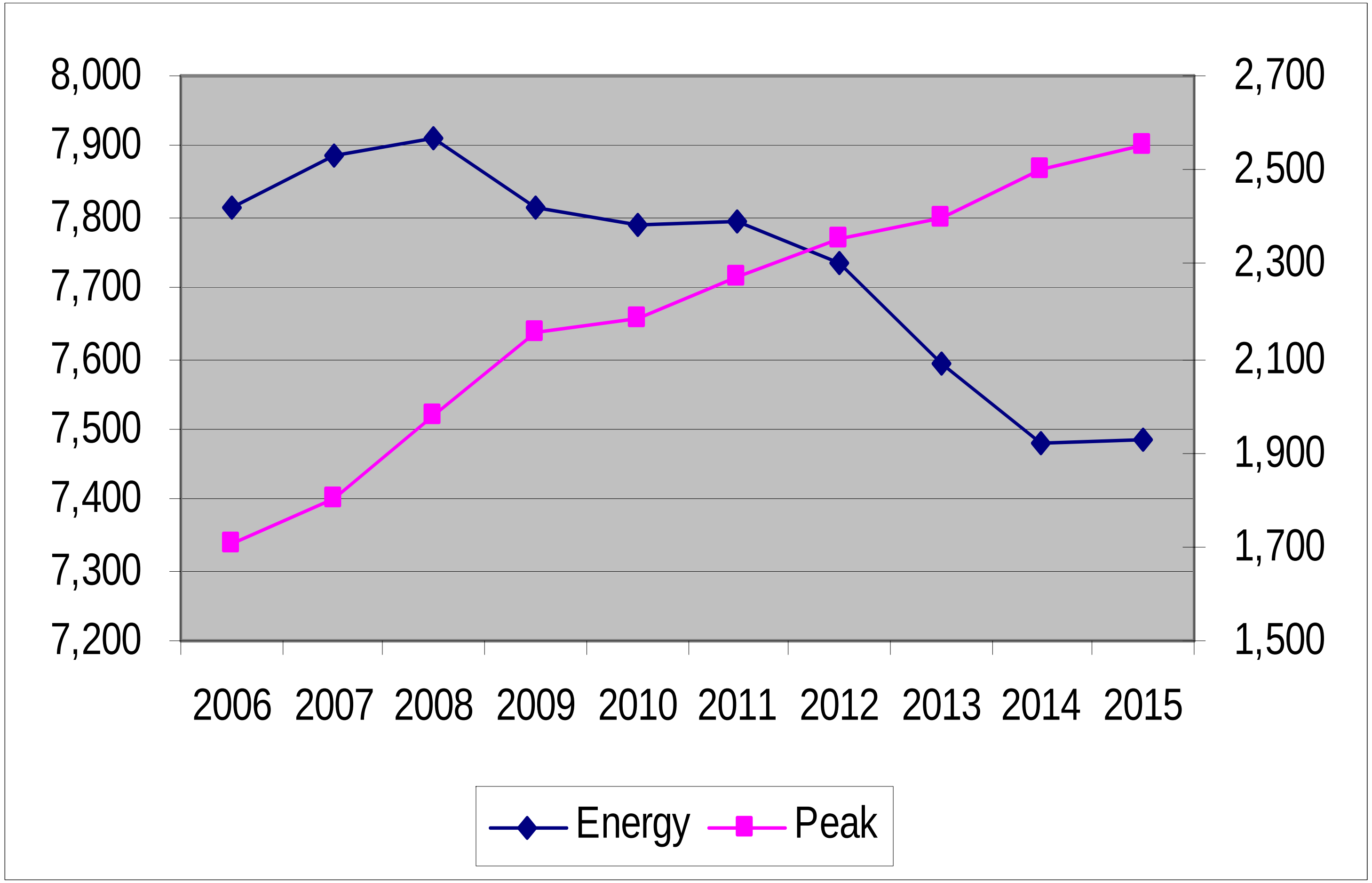
- **Asset Replacement**
  - Asset life extension programs are now maturing (e.g. poles staked in the 1990's now require replacement)
  - To maintain service reliability, assets that may suffer in-service failure are being replaced (eg cross-arms, fittings, conductor)
  - To improve public safety, a program to replace service wires over the next five years

- **The Climate is Becoming More Challenging**
  - Domestic customers are buying more air-conditioners and more power-hungry appliances – and are using them more often
  - This builds the peak demands on the network
  - UED needs to install larger transformers to supply the additional peak load

Demand & Energy



Major Drivers of Capital Investment Increase

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- **The Climate is Becoming More Challenging**
  - The network needs to be more resilient to the effects of extreme weather events
  - February 09 heatwave and April 08 storms
  - AECOM have produced data that forecast these events to be more common
  - Building assets that are stronger and more resilient to weather extremes
  - Installing new technologies to further reduce bush-fire risk

- **Information Technology**
  - IT expenditure is more “lumpy” than network expenditure due to the short life of the assets and our use of ‘large’ IT systems
  - UED major systems are now over 10 years old and require replacement (e.g. SAP)
  - UED needs to be more responsive to customer requirements and IT plays a significant role in achieving that aim
  - For example, improving information to customers during emergencies

Operating Expenditure Drivers

- **Tender process provided prices into the forecasts**
- **Declining opex profile**
- **Step changes from current period:**
  - Debt raising costs
  - Self insurance
  - Demand management
  - Other regulatory obligations
  - Improved emergency response

Concluding Comments

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- **Enormous change and challenges confront the industry. This proposal ensures that customer impacts are minimised**

- **First real price rise since privatisation due to:**
  - Increase cost of capital; and
  - Ageing asset base
- **Customers will still be on average 23% better off in real terms than 1994**

- **UED has been able to minimise further prices rises due to:**
  - New contracting arrangements; and
  - Continuing efficient asset management practices
- **UED's proposal is structured so that its reliability performance will be maintained even though the assets are ageing and climate events are increasing**

Major areas of capital cost increase

- **Ageing asset profile**
  - Network that "began" construction in the 1950's and 1960's
  - This graph indicates that UED is entering a new increased phase of expenditure requirements