



Wesfarmers Limited

ABN 28 008 984 049

Submission to the Australian Energy Regulator in relation to the Powerlink Regulatory Proposal 2013 – 2017

Submitter: Wesfarmers Limited ABN 28 008 984 049

1. Overview

Wesfarmers Limited (Wesfarmers) welcomes the opportunity to present its views on Powerlink's proposal for the reset of its electricity transmission revenue for the period 2012/13 to 2016/17.

This submission raises some important issues regarding the Powerlink proposal and the revenue determination process that are of concern to Wesfarmers. Wesfarmers is keen to discuss these issues with the AER to explain its concerns more fully, and to discuss how they might be addressed.

In summary, Wesfarmers' key concerns are as follows:

- **Proposed revenue and price increases** - Powerlink is proposing to approximately double its annual revenue over the next 6 years, from \$734m in 2010/11 to \$1.446bn in 2016/17. Based on credible energy consumption forecasts, this will result in an approximate doubling of Powerlink's network charges over the next 6 years (from \$15.88/MWhr to \$31.28/MWhr). As indicated by the EUAA and others, this may well represent the highest proposed growth in network charges in the NEM during this period.
- **The use of non-credible energy consumption forecasts** - of over 30 times the trend growth rate of the past 5 years
- **A proposed record level of capital expenditure** - that appears to us to be highly questionable on a number of grounds
- **A proposed record level of operational expenditure** - that is also highly questionable on a number of grounds
- **The proposal of an excessive WACC makeup** - including a debt risk premium (DRP) that is well in excess of the premium Powerlink is likely to incur
- **A proposed decrease in service performance levels** - despite the significant increases in prices
- **A revenue determination process that is misaligned with the National Electricity Objective**

2. About Wesfarmers Limited

Wesfarmers is a major diversified Australian public company. Our businesses span a wide cross-section of the Australian economy including retailing (where our businesses include the Coles group, Bunnings, Kmart, Target, Officeworks and Blackwoods), insurance, resources (largely coal

mining) and industrial operations in energy processing and marketing, chemicals and fertilizers and industrial and safety supplies. Our annual revenue in 2010/2011 was approximately \$54 Billion, we have more than 490,000 shareholders and provide direct employment to approximately 198,000 people, and indirect employment to many more through our supply chain and capital investment.

In respect to our direct engagement in Australia's energy markets as a supplier, we supply coal for domestic electricity generation in three States (as well as export large volumes of coal as well) and retail (largely bottled) LPG nationally. We also provide bulk LNG as a transport and generation fuel in Western Australia.

We currently spend over \$350m buying electricity for our retail and industrial businesses each year, as well generating a significant amount of electricity in our own right. While this may be a small portion of our total cost of sales, this belies its strategic significance to us and to our customers. Our retail businesses all operate in very competitive environments where supply chain efficiency and cost reduction is a continual challenge. Significant rises in the cost of doing business, such as we have seen in recent years for electricity, puts pressure on these businesses. The rising price of electricity also affects our suppliers, amongst them many of Australia's farmers, food producers and many small product and service providers. Our customers will ultimately have to bear higher prices for the goods that we provide if our internal efficiency gains are unable to keep pace with external cost increases. The AER will be well aware of the acute sensitivity in Australia to cost of living pressures in general, and rising electricity prices in particular.

In preparing this submission Wesfarmers has considered, and concurs with, many of the concerns raised other submissions we are aware of (e.g., the submissions of the EUAA and *the GROUP*).

3. Price Increases

Powerlink's annual network charges (\$/MWhr) are dependent on two factors:

- Powerlink's annual revenue; and
- The annual energy delivered (MWhrs) by Powerlink's network.

Powerlink is proposing that its revenue will approximately double over the next 6 years - from \$734m in 2010/11 to \$1.446bn in 2016/17.

Powerlink's proposal does not discuss its assumed 'energy delivered' when calculating its price impacts. However, based on credible energy consumption forecasts, Powerlink's average network charges will closely track its revenue increases, resulting in an approximate doubling of Powerlink's network charges over the next 6 years (from \$15.88/MWhr in 2010/11 to \$31.28/MWhr in 2016/17). This equates to an average annual increase of 15%. As indicated separately by the EUAA, this may well represent the highest proposed growth in network charges in the NEM during this period.

4. Energy and Demand Forecasts

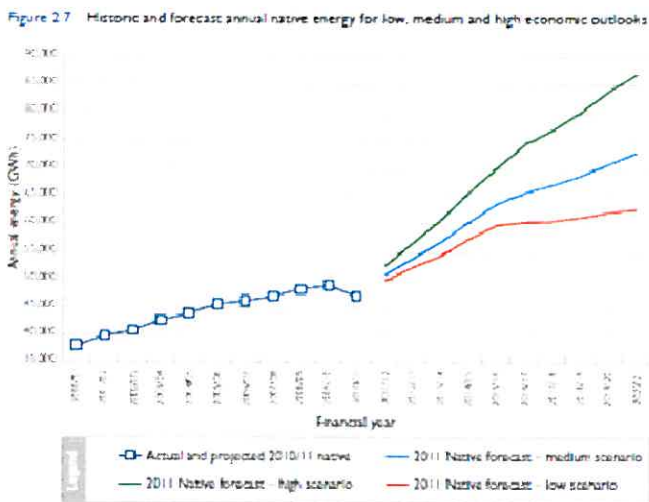
Around two thirds of Powerlink's proposed capital expenditure is predicated on energy growth.

However, as outlined within the submissions of the EUAA and others, Powerlink's energy and demand forecasts do not appear to be credible.

For example, according to Powerlink’s 2011 Annual Planning Report, over the 5 year period from 2005/6 to 2010/11, the energy delivered by Powerlink’s network increased by approximately 1.3% (i.e., an average growth rate of around 0.2% per annum). Despite this trend, Powerlink’s Annual Planning report projects that energy consumption will increase by 35% over the next 5 years (i.e., an average annual growth rate of over 6% p.a.). In other words, Powerlink is assuming an energy growth rate of over 30 times the trend growth rate of the previous 5 years.

As indicated by Professor Ross Garnaut in his recent update report for the electricity sector, over the past 3 years there has been a considerable deceleration in the growth in Australia’s electricity consumption. Garnaut suggests that this is partly due to consumers moderating their electricity usage in response to higher prices, and also due to improved insulation and other energy efficiency measures, plus some contribution from the increased penetration of household solar PV systems.

This trend is evident from Table 2.7 of Powerlink’s Annual Planning Report (see below) which identified that the energy delivered by Powerlink’s network dropped in 2010/2011.



In light of the above observations, Wesfarmers considers that Powerlink’s energy and demand projections are likely to be overstated and unreliable. This has very serious implications for many aspects of Powerlink’s proposal, particularly its proposed capital expenditure, its proposed OpEx, and the price impacts of its proposal (\$/MWhr).

5. Capital Expenditure (capex)

Starting Asset Base

Wesfarmers notes that the Rules allow for all actual capex to be rolled into the asset base at the start of the next regulatory period without any review of its efficiency.

As of the end of June 2010 (the end of the fourth year of the current regulatory period), Powerlink was \$270m underspent compared to its regulatory allowance. However Powerlink is proposing to “catch up” its capital expenditure in the final year, suggesting that it will spend almost \$800m in 2011/2012. This would bring Powerlink’s total capital expenditure to above its regulatory allowance for the current regulatory period.

To achieve this level of capital expenditure in 2011/12, Powerlink will have to expend more than it has ever done in any previous year. It would require Powerlink to expend around twice as much as it spent in the previous two years, and almost twice as much as its regulatory allowance for the current year. Wesfarmers agrees with the views expressed within other submissions to the AER, that such a level of capital expenditure in one year would be unlikely to be expended efficiently.

Wesfarmers also notes the analysis performed by 'the GROUP', which identified that by 'back ending' its capex spend during the current regulatory period, Powerlink will realise a windfall benefit of over \$66m. Wesfarmers also notes that Powerlink's proposed CapEx for the next regulatory period is again front end loaded, presenting the potential for Powerlink to realise even higher windfall benefits by 'back-ending' its spend over the next regulatory period.

Proposed CapEx

Powerlink has proposed a total capital expenditure of \$3.947 billion dollars over the next regulatory period. This would result in Powerlink spending approximately 1.5 times the average annual capital expenditure of the current regulatory period, and approximately 4.6 times the average annual capital expenditure of the previous regulatory period.

Powerlink's proposed capital expenditure has been formulated based on a "scenario forecasting" model, with no justifications being provided for the individual projects. Wesfarmers is concerned that this diverts attention from, and avoids scrutiny of, the prudence and timing of the individual projects being proposed.

Powerlink has listed a number of specific projects in its proposal that it considers should be implemented. Wesfarmers considers it prudent that the AER, as an independent regulator, undertakes a thorough review of the economic and technical justifications of all significant capital projects being proposed, to assess:

- (i) The project needs and justifications
- (ii) The efficiency of the proposed project costs
- (iii) The optimal timing of the projects
- (iv) Whether some projects should more appropriately be classified as contingent projects

Replacement CapEx

Approximately one third of Powerlink's proposed CapEx is for asset replacements.

Most transmission assets have average lives of 40-50 years, which on average, would result in replacing approximately 10% of the network asset base over a 5 year regulatory period.

Wesfarmers notes that, as per the previous regulatory period, Powerlink is proposing the replacement of over 20% of its regulated asset base over the next 5 years (i.e., a rate of over twice the expected long-term average).

Whilst there may be valid reasons for this, the Powerlink submission we don't have access to the information needed to assess the proposals and accordingly Wesfarmers requests that the AER carefully scrutinises Powerlink's asset replacement justifications.

Non Network Alternatives

Wesfarmers is concerned that cost effective alternatives to network augmentation (demand management and embedded generation) do not appear to have been appropriately considered by Powerlink, despite its obligations to do so.

The AER is obliged to only allow the costs of network augmentation where they can be shown to be the lowest cost alternative. Wesfarmers expects the AER to ensure that non-network alternatives have been appropriately considered for all projects proposed by Powerlink. We have particular interests and expertise in demand management and embedded generation which we would be pleased to share with the AER to assist in assessing this case.

6. Operational Expenditure

Powerlink has proposed a total operational expenditure of \$1.094 billion for the next regulatory period. This would provide Powerlink with an average annual operating expenditure allowance of 1.5 times the average operating expenditure of the current regulatory period, and almost 3 times the average annual operating expenditure of the previous regulatory period. Powerlink's proposed annual opex for the final year of the new regulatory period is 4 times its annual opex at the start of the previous regulatory period.

Operational Efficiency

As the AER is aware, Powerlink focuses on the Opex/RAB ratio as the key indicator of its operational efficiency. Wesfarmers notes that this ratio significantly favours entities such as Powerlink which have undertaken major increases in capital expenditure in recent years, providing them with high asset values and with the benefits of the lower operational and maintenance costs associated with newer assets.

However, even using this ratio, Powerlink's Opex/RAB was higher in 2008/09 than it was in 2001/02, despite having doubled its regulated asset base during that period. Also, under Powerlink's proposal its Opex/RAB ratio will increase from 2.45 to 2.54 over the next regulatory period.

Wesfarmers shares the views of the EUAA and others regarding the inappropriateness of the Opex/RAB ratio as a measure of operational efficiency. Wesfarmers considers that other ratios such as Opex/MWhr may provide a more meaningful indication of Powerlink's operational efficiency.

Wesfarmers notes that, should Powerlink's proposed opex be approved, then its Opex/MWhr will more than triple by the end of the next regulatory period compared to the start of the previous regulatory period with consequent cost implications for users that are difficult to mitigate.

Wesfarmers also shares the concerns raised by the EUAA and others regarding Powerlink's use of ITOMS data as a demonstration of its operational efficiency. As highlighted by the EUAA, the ITOMS results presented in Powerlink's submission are not an indicator of operational efficiency, as they only benchmark the direct labour costs of selected maintenance activities, which account for less than 10% of Powerlink's operational costs.

Efficient Base Year?

Powerlink claims that it achieved optimum opex efficiency in 2009/10, and uses this as the basis for developing its forecast opex.

Wesfarmers does not accept that Powerlink's 2009/10 opex should be assumed to represent an "efficient" basis for its future opex, particularly given that Powerlink's 2009/10 opex was around twice its 2005/06 opex, without additional detailed supporting information.

Wesfarmers suggests that the AER needs to adopt a rigorous approach to the assessment of an efficient opex baseline, based on credible independent benchmarking.

Powerlink also claims that during 2009/10 there were no significant "one off" costs that should be excluded from its proposed base year. Powerlink then goes on to claim a list of "new requirements" it considers should be added to the base year costs when setting its future years' opex.

Wesfarmers concurs with the concerns expressed within other submissions provided to the AER, that most of the items listed on page 90 of Powerlink's proposal are likely to be recurring expenditure items rather than "new requirements".

Wesfarmers urges the AER to examine this aspect of Powerlink's proposal in some detail.

Powerlink is forecasting a step increase in opex of 16% between its projected 2011/12 opex and its proposed 2012/13 opex (increasing from \$161.5M to \$187.4M). Wesfarmers considers that such a step increase is not justified on the basis of Powerlink's proposal.

Economies of scale factors

Wesfarmers considers that the scale factors Powerlink proposes to be applied to the determination of its future opex are significantly overstated compared to scale factors that would apply to an efficient asset management business. Based on Wesfarmers' experience in managing asset intensive businesses, Wesfarmers concurs with the findings of the analysis performed by 'the GROUP' which concluded that more appropriate scale factors should be as follows:

- Maintenance Support – less than 15%
- Network Operations – less than 20%
- Network Planning - less than 10%
- Asset Management Support - less than 10%
- Corporate Support - less than 5%.

Wesfarmers notes that Powerlink has not provided any substantiation for its proposed scale factors. Wesfarmers urges the AER to determine scale factors that would apply to an efficiently run asset intensive business and to apply such scaling factors in its determination of Powerlink's allowable future opex.

As indicated above, on the basis of the data provided by Powerlink, Wesfarmers has serious concerns regarding many aspects of Powerlink's proposed operational expenditure. Consequently, Wesfarmers requests that the AER subjects all components of Powerlink's proposed opex to a high degree of scrutiny.

7. Weighted Average Cost of Capital (WACC)

Powerlink's proposed 'return on capital' (WACC X Asset Value) of \$4.2 billion accounts for 71% of its proposed revenue

A major reason for the large step increases in revenue between the current regulatory period and the new regulatory period can be directly related to Powerlink's proposed WACC. As outlined within the submission of 'the GROUP', if accepted by the AER, Powerlink's proposed WACC represents an increase of around 2% above its current actual level.

Powerlink is proposing that the market risk premium (MRP) be increased from 6% to 6.5%, and that its debt risk premium (DRP) be increased from 1.14% to 4.34%.

As the AER has acknowledged in several forums, its current approach to determining DRP allowances is delivering cost of debt allowances well in excess of the costs being incurred by the network businesses. This appears to be clearly the case for Powerlink.

Powerlink is provided with debt from the Queensland Treasury Corporation (QTC) which raises funds from the market using the Queensland Government's credit rating.

As outlined in Powerlink's 2009/10 Annual Report, the rate of interest paid by Powerlink in 2009/10 was 5.9%, during a year when the risk free rate was 5.49%. Consequently, Powerlink's implied debt risk premium for that year was 0.41%. However, Powerlink's regulatory return was based on a debt risk premium of 1.14%.

Wesfarmers considers that Powerlink's request to increase its DRP almost fourfold (to 4.34%) is excessive. Wesfarmers urges the AER to use the Powerlink determination to place a 'line in the sand' and to start to set regulatory returns that match reality, by setting Powerlink's allowable DRP based on what Powerlink actually pays, or is likely to pay.

8. Reliability

Wesfarmers is concerned that, despite the significant price increases being proposed, Powerlink is proposing reductions in service performance during the next regulatory period. In essence, under Powerlink's proposal, consumers will be expected to pay significantly higher prices for a lesser service.

Wesfarmers considers that the magnitude of Powerlink's recent and proposed CapEx should result in improved service performance levels. Wesfarmers notes that Powerlink's submission does not provide any discussion on the bonuses Powerlink received during the current regulatory period under the service performance incentive scheme.

Wesfarmers agrees with the comments of the EUAA and others that there is a prima facie case that the service performance targets are being set too low, and that meaningful "stretch targets" need to be applied to ensure that consumers are not simply paying an incentive bonus for the better performance that the increased capital expenditure, should in any event, bring

9. Misalignment of Revenue Determination Process with the National Electricity Objective

Wesfarmers refers to the speech delivered by the AER Chairman, Mr Andrew Reeves, on 20 June 2011, where he acknowledged the shortcomings of the revenue determination process and committed the AER to progressing improvements to the process to strike a better balance between the interests of network businesses and those of consumers.

The key role of the AER as the economic regulator of monopoly electricity networks is to ensure that consumers are not paying more than is necessary for their electricity services. This concept is enshrined in the National Electricity Objective and is set out in the National Electricity Law. In essence, the objective set out in the law is *"to promote efficient investment in and efficient operation and use of energy services for the long term interests of the consumers of energy"*.

It is clearly important that the AER delivers revenue determinations that meet this objective while ensuring security of supply and the like.

As outlined by the AER Chairman, *“the AER needs to be sure that we are only making customers pay the minimum necessary to meet the cost of an efficient service provider for the safe and reliable supply of energy”*.

The AER Chairman outlined the following key changes that the AER intends to progress to improve the alignment of its regulatory decisions with the National Electricity Objective.

- Improving the AER’s ability to make unbiased forecasts of efficient capital and operating expenditure
- The provision of strong incentives for network entities to spend no more than is necessary and efficient, and to be sure that excessive expenditure is not rewarded
- The need to set a ‘cost of capital’ that properly reflects the networks’ cost of funds, ensuring that the networks receive a commercial return on efficient investment, while ensuring that consumers are not paying for excessive returns.
- Improvements to the merits review process

Wesfarmers makes some brief comments below regarding each of these issues in the context of the Powerlink revenue proposal.

Forecasts of efficient capital and operating expenditure

Wesfarmers agrees with the AER that the existing framework tends to support inflated forecasts from the network entities and places an unfair ‘onus of proof’ on the regulator.

As highlighted by the AER Chairman recently, the current ‘propose/respond’ regime *“provides network businesses with incentives to submit revenue proposals that are at the top of, or beyond, what could be considered a range that ‘reasonably reflects’ the required expenditure”*

As indicated within this submission, there is strong evidence that a number of elements of Powerlink’s proposal may be beyond what would be considered a “reasonable range”. For example, a large proportion of Powerlink’s proposed CapEx and OpEx increases have been justified on the basis of Powerlink’s energy growth assumptions which seem at least questionable based on the past five years history and Australia’s current economic growth performance. Consequently, it would appear that Powerlink has overstated its CapEx and OpEx needs, and hence has significantly understated the pricing impacts (\$/MWhr) of its proposal.

Wesfarmers encourages the AER to progress its commitment to determining efficient forecasts of Powerlink’s capital and operating expenditure. In particular, Wesfarmers notes the AER’s commitment to applying benchmarking, as mandated by the NEM Rules, to assist in determining efficient costs. Wesfarmers considers that transparent independent benchmarking should be an essential element of the Powerlink, and indeed every, revenue determination process.

Efficiency incentives

Wesfarmers shares the AER’s concerns regarding inefficient expenditure being rolled into the capital base, without review of its necessity or efficiency, leading to unnecessary step changes in prices at the start of the new regulatory period.

Wesfarmers draws the AER's attention to Powerlink's intention to undertake an unprecedented level of capital expenditure in the final year of the current regulatory period, which will result in Powerlink exceeding its overall regulatory capital expenditure allowance for the current period.

Wesfarmers urges the AER to increase the incentives placed on network businesses to spend efficiently. This should include measures that strengthen the incentive not to overspend, and measures that reduce the rewards from over-expenditure. As we have indicated in several forums recently none of this should be at the expense of energy security or system efficiency.

Cost of capital

As the AER has acknowledged, the cost of capital allowances being awarded by the AER, do not reflect the actual cost of debt being incurred by the network businesses.

As outlined within this submission, this has clearly been the case for Powerlink during the current regulatory period (based on its own Annual Report), and would continue to be the case if the AER were to accept Powerlink's proposal to increase its debt risk premium almost fourfold in the next regulatory period.

Wesfarmers urges the AER to use the Powerlink determination to progress its commitment to start to set regulatory returns that match real market conditions, particularly for what are essentially regulated monopolies.

Merits review

As the AER has acknowledged, it is clear that the decisions of the hearing reviews of AER determinations have led to significant, and in the view of many consumers, unnecessary price increases for customers. As stated by the AER Chairman, *"the evidence is that a low hurdle has been established to enable review matters to come before the tribunal. This has led to reviews of AER decisions becoming an inevitable part of the determination process"*.

Wesfarmers recommends the need for a more balanced approach to appeals, such as that adopted in the United Kingdom. The UK appeals process effectively re-opens the complete revenue determination, thereby exposing the network entity to the risk of an unfavorable outcome on the complete decision rather than their selected or 'cherry picked' elements. As a result, appeals are very rare in the United Kingdom.

Wesfarmers urges the AER to progress its commitments to the above improvements and to restore the balance of the revenue determination process to give better effect to the National Electricity Objective.

Thank you for the opportunity to comment on this proposal. Should you wish to discuss any element of it please do not hesitate to contact me on 08 9327 4423 or by e mail at cschuster@wesfarmers.com.au.

Yours sincerely,

Cameron Schuster

Sustainability Manager