AUSTRALIAN ENERGY REGULATOR REVIEW OF POWERLINK REVENUE PROPOSAL 2007/08 TO 2011/12

13 June 2006

This submission was prepared by the Energy Users' Association of Australia with assistance from McLennan Magasanik Associates and Sinclair Knight Merz. Funding assistance was provided by the National Consumers Electricity Advocacy Panel. All views expressed are those of the EUAA.

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In general, customers have found that Powerlink is a well run and technically efficient TNSP. It has high caliber management and employees, and is well led. We also applaud Powerlink for facing up to some significant challenges including the high demand growth rates experienced recently during which Powerlink has shown leadership in addressing various significant NEM transmission issues. Among the TNSPs, Powerlink has shown that it is willing to undertake serious engagements with end users including in this Revenue Proposal by agreeing to meet with customer representatives. Its actions in this regard are the most proactive of any TNSP.

We are of the opinion that the AER should accept the positive aspects of Powerlink's operations but also subject the application to close scrutiny, recognising that it is the first transmission review to be undertaken by the AER and that the outcome of this review may be setting the stage for the forthcoming reviews of other TNSPs.

However, in its revenue proposal, Powerlink does not appear to have justified all of the steep increases in cost. Its claims are not always fully transparent and it has not detailed how regulatory obligations have impacted on costs. Powerlink argues that the company is subject to escalating input costs and this justifies expenditure increases. We do not understand why high labour and material costs should affect Powerlink more than other companies.

Companies in a competitive environment cannot simply increase prices otherwise market share will be lost as customers seek more efficient and lower cost suppliers. Such companies will only increase prices as a last resort after exhausting all means to increase their efficiency and productivity. Regulated monopoly companies on the other hand have the luxury of going to a regulator to seek a cost pass through as a first step. Any efficiency gains simply improve the profitability of the company.

Some of our concerns are as follows:

- Powerlink is proposing to spend almost $550M in capital expenditure in 2007/08. In real (2005 $) terms, this is twice as much as the amount Powerlink is expecting to spend in the last year of the current regulatory period. Over the next regulatory period, Powerlink is proposing to spend, on average, over 220% of the amount spent in the current regulatory period and is over 250% above the average amount approved by the ACCC in 2001.
- Powerlink has forecast that average annual opex would be over 65% ($56M) greater than the average annual opex in the current regulatory period. Compared with the opex approved by the ACCC for the current regulatory period, the average annual increase is almost 80% or $62M. Over the regulatory period, in trend terms, Powerlink's proposed opex increase over the opex projected from the

ACCC's previous decision is some 33% or $176M. Even when compared with the trend projection from its actual historical opex, the proposed increase amounts to about $74M (12%).

- Return on capital (WACC X Asset Value) accounts for over 62% of Powerlink's annual revenue requirements over the next regulatory period. This provides strong incentives for ambit claims and exercise of 'strategic behaviour' by regulated entities during regulatory reviews. A 50 basis point difference in WACC results in an approximately $120M change in revenue for Powerlink over the five year regulatory period.
- Consumer groups believe that it is important that electricity users obtain a reasonable level of service from the transmission system. We welcome steps taken to require TNSPs to implement some (limited) service standards, but believe that further steps are needed to establish a more effective and meaningful system of incentives for service. The financial incentive of placing just 1% of revenue at risk is however not going to provide a strong incentive as 99% of the revenue is guaranteed regardless of the level of performance.
- Should any pass through events be accepted by the AER, customers would expect that the AER also ensure that cost reductions are also passed through to customers. Simply depending on Powerlink to inform the AER and customers that costs for these events were lower than expected are not sufficient. The AER needs to consider that regulated businesses, such as Powerlink, will have little if any incentive to draw such matters to the attention of the regulator and end users are not in a well informed enough position to do so.
- Under the Powerlink Revenue Proposal, Powerlink's EBITDA will increase by over 72% to almost $590M in 2012 over the EBITDA reflected in the 2004/05 Annual Report. Average TUoS payable will increase from the $9.26/MWh (forecast 2006/07) to $10.22/MWh in 2007/08, a 10.4% increase in the first year of the next regulatory period. The increase will continue despite growth in energy demand in 2007/08 of over 4% pa. With average price increases of this order of magnitude, the AER must recognise the impact it would have on Queensland customers including EUAA members.

1 INTRODUCTION

We appreciate the opportunity to provide comments for consideration in response to Powerlink's transmission revenue proposal to the Australian Energy Regulator (AER). We are undertaking further investigation of Powerlink's proposed cost increases and would like to provide a supplement to this submission.

The transmission system is critical to the proper functioning of the NEM, not just in the reliable bulk transportation of electrical energy but also in stimulating competition, trade and liquidity. Its importance goes beyond the direct costs of transmission use of system (TUoS) but also impact on the wholesale cost of energy when inter-regional transmission constraints are relaxed. Recognising this, customers may be prepared to accept some degree of "over investment" if we can be assured of offsetting benefits in higher reliability and lower wholesale energy market prices. However, allowing for this, Transmission Network Service Providers' (TNSP) costs still need to be "efficient" and subject to close regulatory scrutiny and the AER will have a critical role in balancing these factors.

In general, customers have found that Powerlink is a well run and technically efficient TNSP. It has high caliber management and employees, and is well led. In many ways Powerlink has done a 'good job' for Queensland and the recent electricity supply problems faced by the state have not been caused by Powerlink. We also applaud Powerlink for facing up to some significant challenges including the high demand growth rates experienced recently during which Powerlink has shown leadership in addressing various significant NEM transmission issues, eg QNI upgrade and providing submission in response to the Australian Energy Markets Commission (AEMC) Issues Paper considering congestion management.

Among the TNSPs, Powerlink has shown that it is willing to undertake serious engagements with end users including in this Revenue Proposal by agreeing to meet with customer representatives. Its actions in this regard are the most proactive of any TNSP.

Powerlink has submitted a lengthy and detailed application covering some complex issues. Its application provides a useful starting point for this review but it has some gaps and raises some important questions.

We are of the opinion that the AER should accept the positive aspects of Powerlink's operations but also subject the application to close scrutiny, recognising that it is the first transmission review to be undertaken by the AER and that the outcome of this review may be setting the stage for the forthcoming reviews of other TNSPs.

Customers expect the AER to take into consideration the impact transmission price rises will have on the input costs of major energy users, as well as the competitiveness of the Australian economy and the need to keep inflation pressures under control (as espoused recently by Treasurer Costello). We also expect the AER to recognise that all businesses in

Australia face similar cost pressures to Powerlink but are not able to pass through such costs via a regulatory determination; they might pass through some proportion but must also look to make greater efficiencies in their operations or lose competitiveness and market share.

Our submission addresses the key issues of concern to our members and we seek to ensure that these issues are considered by the AER prior to making its draft decision. It is our view that the revenue proposal has significant deficiencies and consequently cannot be approved without major amendments.

Our major issues discussed in this submission are:

- Capital Expenditure (capex) in the current regulatory period has significantly increased compared with Powerlink's previous forecasts used for setting the revenue cap for the current regulatory period. In addition, the current capex forecasts for the next regulatory period continue the trend of high rates of investments.
- The Weighted Average Cost of Capital (WACC) requested by Powerlink is not justified considering the risk reward trade off.
- The significant increase in Operation and Maintenance (O&M) expenditure over the current and next regulatory periods.
- The importance of Powerlink's performance standards in servicing end users and the inadequacy of placing only 1% of revenue at risk.
- The increase in average TUoS charges faced by consumers as a result of the current revenue cap application.

In its proposal, Powerlink claims that it faces unique circumstances. These include:

- Geography / decentralisation
- High demand growth
- Reliability of supply obligations
- Generation development
- Increased regulatory obligations: vegetation / environmental / safety / planning

We note that all these "unique" factors have a cost increasing impact. However, we have to ask how unique is Powerlink? While we do not doubt that all the above factors have an impact, other TNSPs have other "unique" issues and have raised them with the regulator at every review. This has been our experience in every TNSP price review. The AER needs to test these claims and their cost impacts and ensure that they are well founded. It also needs to test that there are no offsetting factors where costs can be lowered and generally ensure that Powerlink has efficient costs and will continue to do so over the next regulatory period.

Powerlink does not appear to have justified all of the steep increases in cost. Its claims are not always fully transparent and it has not detailed how regulatory obligations have impacted on costs. Generation development has also been cited as a reason for higher costs. However, as Powerlink themselves have noted, generators should pay for their connection and the costs incurred should have been excluded from its Revenue Proposal. Powerlink argues that the company is subject to escalating input costs and this justifies expenditure increases. However, we do not understand why high labour and material costs should affect Powerlink more than other companies.

In assessing the proposal, the AER needs to ask how companies in a competitive industry behave in response to such cost pressures. Do they simply raise prices by adopting a cost-plus approach? Or will they seek to:

- Increase productivity / efficiency;
- Seek innovative ways to manage the increases; and
- Absorb some cost pressures.

The Australian Financial Review[1] reported that Rio Tinto's Chief Executive Leigh Clifford "suggests in the annual report that high oil and gas prices are here to stay and could ultimately improve efficiency. "These factors may represent a structural increase for costs in our industry, but we are constantly looking for ways to use energy more efficiently and improve productivity across all of our operations," he says" and Powerlink needs to do the same.

Companies in a competitive environment cannot simply increase prices otherwise market share will be lost as customers seek more efficient and lower cost suppliers. Such companies will only increase prices as a last resort after exhausting all means to increase their efficiency and productivity. Regulated monopoly companies on the other hand have the luxury of going to a regulator to seek a cost pass through as a first step. Any efficiency gains simply improve the profitability of the company. The AER needs to asses the Powerlink application carefully in light of this.

The Federal Treasurer recently warned in relation to oil prices, that we should be vigilant against simply passing through cost increases as that would lead to an inflationary spiral, and that inflation can be contained as long as businesses do not increase their prices because of the rise in input prices.[2] The AER needs to ensure that higher costs faced by Powerlink are addressed by higher efficiencies rather than passing these costs through to customers.

We have seen companies absorbing large cost increases to achieve a competitive advantage. Virgin Blue resisted passing through the cost of higher oil prices to airfares,

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[1] The Australian Financial Review, *Soaring oil price fuels transport costs,* 20 April 2006

[2] The Australian, *Oil shock an inflation risk: Costello,* 20 April 2006

despite Qantas, its only competitor, imposing a fuel levy. Businesses in a competitive environment do not pass through cost increases unless absolutely necessary as doing so could erode a competitive advantage. This competitive behaviour, however, seems lost on regulated network businesses and seems to be absent from the Powerlink application.

2 REGULATORY ASSET BASE AND CAPEX

2.1 Asset Base Roll Forward

The AER should be aware that customer groups have always held the view that the historical Optimised Depreciated Replacement Costs (ODRC) method used to determine the asset base at the start of the sectors reforms overstates the value of assets. While we agree that constant revaluations create uncertainty and adversely impact on the cost of equity, it is our view that the AER still needs to check that the roll forward is robust and justified. In this regard, we are very concerned with the impact of once off rolling in of $530M worth of assets under construction. The Revenue Application notes a change of timing for recognition of expenses from "as commissioned" to "as incurred" under the *ex-ante* expenditure cap. This change should be accompanied by removal of interest payments during construction. There is no mention of current policy or whether this has changed in the cost estimates used in the submission. Confirmation is required that future capital forecasts do not include interest payments during construction.

This change from "as commissioned" to "as incurred" account for over 16% of RAB and at a WACC of 8.34% as sought by Powerlink, this once off addition will increase revenue requirement by over $44M.

The value of assets under construction will only get larger as the capex programme expands. There also seems to be a logical inconsistency with these assets under construction being depreciated even before they are completed and put into service! As a result of this change, customers are required to pay for these assets even before they provide any service! We urge the AER to review this capitalisation policy, especially since it does not comply with any accounting standards.

2.2 Capital Expenditure

Based on the available documents submitted by Powerlink for this review, we understand that Powerlink's Capex forecast has been based on the following:

- Load forecast based on 10-year demand and energy forecast for Queensland DNSPs and direct connected customers
- Wholesale market modelling to identify plausible generation patterns for the Queensland region over the next 10 years
- A suite of likely augmentation projects developed by Powerlink
- A suite of likely transmission connections (including additional connection point capability between Powerlink and the DNSPs)
- A suite of likely Easements and Land acquisitions

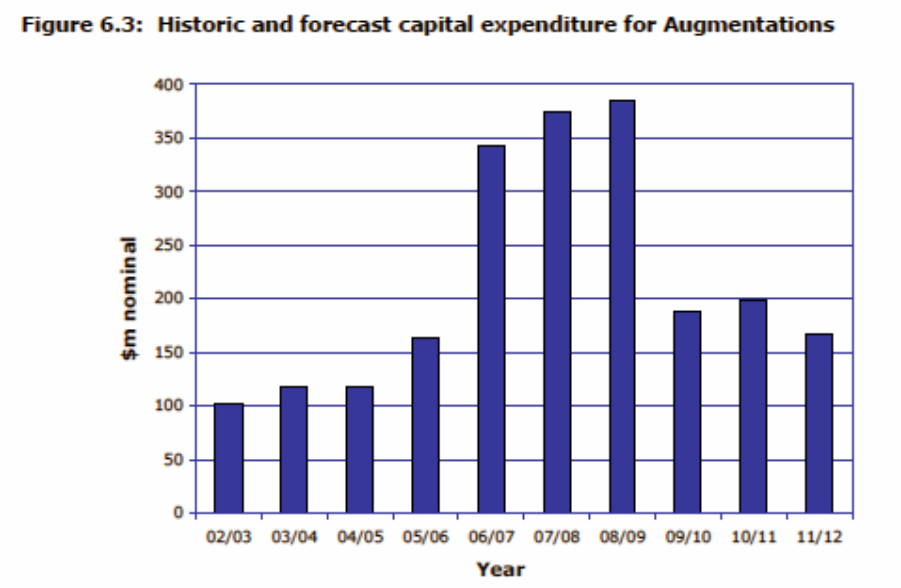
- Replacement of aging assets
- Security / Compliance and other non-load driven investments

In general the reasons given for increased capital expenditure within Powerlink's submission appear reasonable, and reflect similar issues facing other networks around Australia. However, the submission details explaining the cost increases are generally in narrative form (qualitative) and the actual value of the increases need substantiating.

We do not believe that comparisons in the submission with the increases in Capex recently awarded to Queensland's Distribution businesses are valid. Queensland's DNSPs have underspent for a period[3] and part of their increase in Capex is a "catch up" of previous underspending. In part, this underspending was due to DNSP's relaxed network security criteria in the absence of regulated requirements. In the case of TNSPs, the National Electricity Code (now Rules) has been in place for almost a decade, and contain requirements for transmission network security that have not been changed. On this basis, it should not have been possible to under-invest in transmission assets in the same way that was done for distribution assets, and hence the capex increases required by DNSPs are not necessarily justified for transmission. Powerlink's submission does not note any previous underspending.

Figure 2.1, taken from p65 of the Powerlink submission, shows Powerlink's historical and forecast augmentation expenditure.

Figure 2.1 Powerlink's Augmentation Expenditure



[3] Detailed Report of the Independent Panel - Electrical Distribution and Service Delivery for the 21st Century Queensland July 2004

Figure 2.1 shows a significant lump of expenditure in the early years of the next regulatory period, followed by a return to levels more in line with recent capex levels. It is unclear from the submission whether this lump is due to:

- a "catch up" factor;
- the impact of changed capitalisation policy on current Work In Progress (WIP[4]), or
- the outcome of the required timing of projects.

2.2.1 Ongoing Capex

Some $348M of ongoing works on current projects has been identified (Table 6.2, p58). It is unclear whether these projects and costs are included in the project list used as the basis for forecasts, or if are they treated separately. This should be clarified.

2.3 *Ex-ante* Capital Cap

The rationale behind switching to an *ex-ante* cap on capex is that this will impose greater discipline on TNSPs capital expenditure, and also provide certainty to users in terms of capex and hence future regulated TUoS. There are, however, a couple of potential weaknesses in this approach:

- The proposal, and hence accepted value, is based on forecast growth and project costs. If growth or delivered costs are lower (and the probability should be equal that it be higher or lower if we are using the forecast growth figures), then in theory TNSPs could spend in excess of what is strictly "prudent", up to the accepted cap. (To overcome this, would require a detailed *ex-post* assessment on top of the current *ex-ante* assessment). That is, the *ex-ante* cap does not necessarily guarantee only prudent levels of future expenditure.
- If growth is higher than expected, TNSPs are likely to hold back on projects not included in the *ex-ante* approved budget, until they can be approved in the next regulatory period. That is, flexibility to adapt is constrained during a 5 year planning horizon, which given historical experience with the accuracy of load forecasts, is not necessarily a prudent approach.
- In Queesland, demand growth is forecast to continue to be high and, as a result, Powerlink is likely to apply for a higher ex-ante cap to ensure that the approved ex-ante cap is sufficient even to meet unexpectedly higher growth. If, however, this growth does not eventuate, customers will be bearing the additional costs this methodology has imposed.

[4] Though if this is the case, it would be expected to see the expenditure in the first year not spread over three years

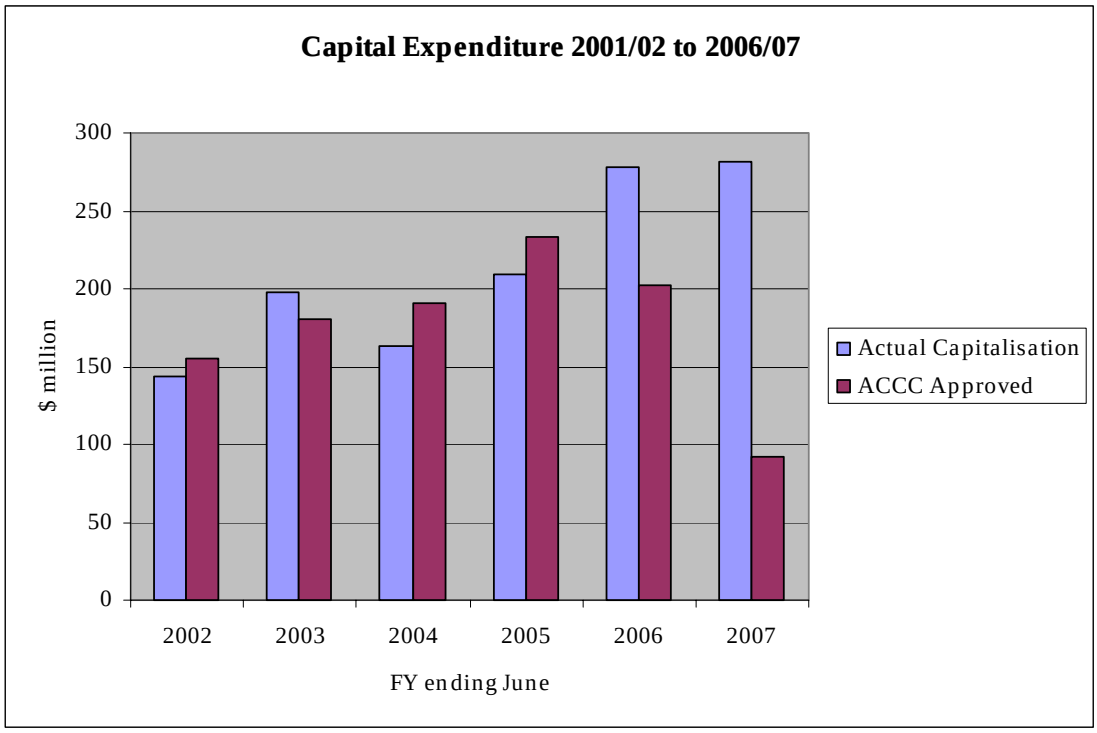
2.4 Historical Capex

In its decision in 1999, the ACCC determined that Powerlink's forecast of capex between 2001/02 and 2006/2007 would total $1,043M.[5] In inflation adjusted terms, Powerlink estimates that it would be actually spending a total of $1,274M. This amounts to over spending by 21% of the capex forecast at the beginning of the current regulatory period. Electricity consumers, including our constituents, would be concerned with a regulatory arrangement that simply allows the monopoly regulated entity to over spend its allowed capex by such a huge margin and then bill its customers the difference during the following regulatory period by rolling in the increased costs to its asset base, asserting that the overspend was efficient.

An analysis of the timing of the capex shows that most of this additional expenditure occurs (or is expected to occur) in the latter half of the regulatory period. In the first 3 years, between 2001/02 and 2003/04, average capex was $168Mper year. In the second 3 years, 2004/05 to 2006/07, capex is expected to increase to $257 per year, a 53% increase over the previous 3 years. On the other hand, the ACCC had expected capital expenditure to peak in 2004/05 and then decline. In the last year of the current regulatory period, Powerlink is estimating that its capex would be over 300% of the amount the ACCC approved in 2001/02. This is shown in Figure 2.2 below. The reasons for this need to be carefully investigated by the AER and made public so that end users can be confident that the increase is justified. For example, it may be that some increase in expenditure is justifiable. On the other hand, we would be extremely concerned it Powerlink were to simply ramp up capex in the second period to increase its opening RAB in the next regulatory period resulting in higher revenues.

[5] ACCC, Decision, Queensland Transmission Network Revenue Cap 2002-2006/07, Nov 2001

Figure 2.2 Powerlink Capex 2001/02 to 2006/07



At a minimum, the AER should consider commissioning its engineering consultant to undertake a study of the reasons for the large increase in capex and evaluate the efficiency of all of the capex Powerlink spent (and is claiming will be spent) in the current regulatory period.

This needs to go beyond what is "reasonable" to what is "efficient" in terms of Powerlink's privileged role as a monopoly TNSP in Queensland.

Based on the outcome of the evaluation study, the AER should only allow rolling in of any increased costs of capex related to meeting increases in customer demand. The cost of alternatives to network augmentation, for example, demand management in the shorter term and distributed generation, should be considered in determining capex. It is important that the cost of network augmentation should only be allowed where it can be shown to be the lowest cost alternative.

Powerlink, as the asset owner, must have the incentive to manage and maintain its assets so as to minimise the total life cycle cost. Allowing Powerlink to simply roll into its asset base any cost increases would undermine and negate the whole concept of incentive regulation. Incentive is based on the premise that, should the TNSP achieve efficiencies that lead to lower capex spend in any period, it would be able to keep the benefits of this lower expenditure. As claw back is considered to diminish the incentives for the TNSP to be innovative and efficient, so too would simply rolling in overspending of such a large nature.

Consumers expect detailed assessments and consistency in this regard.

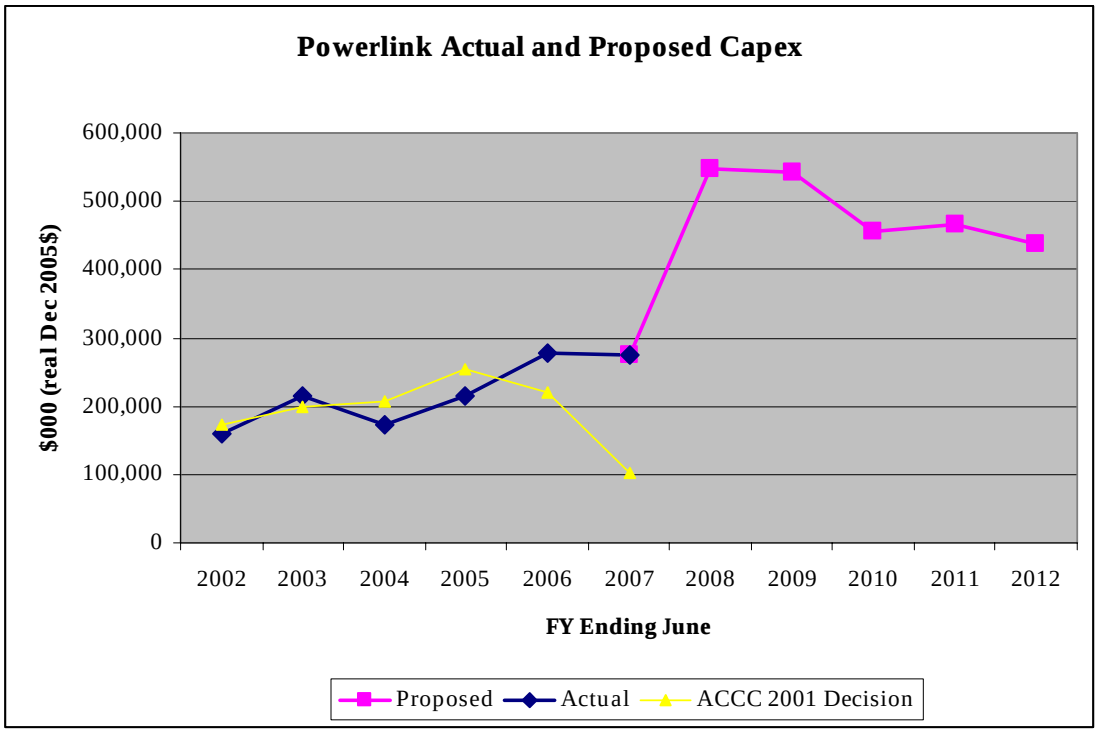
2.5 Proposed Capex

To justify its application, Powerlink should be asked to provide a detailed statement of the scope and timing of their proposed capex program that should be subjected to detailed scrutiny by suitably qualified engineering consultants and be benchmarked against comparable businesses both here and overseas. This should identify the purposes for this expenditure and provide a proper allocation of costs to the respective beneficiaries of each project or class of development work. This approach will enable the AER to critically assess Powerlink's claims and set a capex level, which is justified, feasible and acceptable to electricity consumers.

Figure 2.3 also highlights another concern regarding Powerlink's capex forecast. Powerlink is proposing to spend almost $550M in 2007/08. In real (2005 $) terms, this is twice as much as the amount Powerlink is expecting to spend in the last year of the current regulatory period. Over the next regulatory period, Powerlink is proposing to spend, on average, over 220% of the amount spent in the current regulatory period and is over 250% above the average amount approved by the ACCC in 2001. Capex increases of such magnitude (in real terms) must be subjected to detailed scrutiny by the AER.

We also note that Powerlink's Revenue Proposal provides for the replacement of Cyclone Larry affected assets in its capex forecast. No mention is made, however, of whether these assets were insured or self insured. If self insured, should these costs come from the self insurance reserve (ref opex costs p107), rather than regulated capex?

Figure 2.3 Powerlink's Actual and Proposed Capex



2.5.1 Load Forecast

ROAM Consulting's report appears to indicate that load forecasts were one of the variables used in developing the 40 scenarios modelled for Powerlink[6]. If this is the case, the load forecasts used should be identified and it would also be informative to split the scenarios / expenditure outcomes into High / Medium / Low load growth groups.

Reference has been made to an average summer maximum demand increase of 4% p.a., which is considered reasonable and in line with other forecasts for Queensland, including NEMMCO's and the DNSPs'. We note that due to the long lead times associated with some elements of transmission projects, any slowing in growth would take time to impact on annual capital expenditure given the 5 year regulatory period.

We also note that augmentations seem high compared to connections (see Table 2-1). It is unclear where these increased loads will come from if they are not customer connections. It should be noted that these values exclude new generator connections as these are categorised as unregulated assets[7]. Based on the above, we consider that more details on the levels of augmentation required for the Powerlink network should be supplied to clarify this difference in expenditure.

[6] ROAM Consulting, *Identification of Generation Development Scenarios*, 5 September 2005 (attachment to Powerlink submission)

[7] Response to question raised by EUAA at AER Public Forum held 20th April 2006

Table 2-1 Historic and forecast capital expenditure for augmentation and connection

$M (nominal)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Augmentation	102.41	117.97	117.79	162.89	342.64	374.86	385.64	187.86	198.74	167.08
Connection	27.90	8.19	8.49	11.19	32.38	24.39	8.00	13.37	12.35	16.72

Numbers exclude generator connection costs

2.5.2 Generating Scenarios, Augmentation and Connections

In general, the probabilistic scenario approach taken by ROAM seems acceptable, and a reasonable way of dealing with the high level of complexity and uncertainty regarding future generator options, locations, and timing. However, the sophistication of this analysis tends to take the focus away from the assumptions underlying it, which is likely to have a high degree of impact on the outcomes. Specifically:

- *The prudency of individual projects.* Details regarding the need for individual projects are not included, based on objective planning criteria, and whether each project passes (or is likely to pass) the Regulatory Test criteria at the projected completion date. Likewise there is no discussion of alternatives considered for each project, nor whether the scope (design, specification etc) is prudent and in accordance with best industry practice.
- *The timing of individual projects.* There is no discussion of the timing of individual projects, and whether this is optimum, or if some could be cost effectively deferred. SKM notes the timing of projects appears to be "fixed" under all scenarios, when it would seem likely that different projects would occur at different times under varying scenarios, especially if demand forecasts are one of the variables used to generate the 40 scenarios.
- *Cost estimates for individual projects.* The basis for cost estimates is not discussed in detail, nor whether these have been independently reviewed, or benchmarked against recent projects to ensure prices are realistic and efficient.

It is likely that the above issues could have at least as big an impact on the final outcome as the probabilistic scenario; however the discussion focuses on the scenarios and probabilities, rather than the underlying projects.

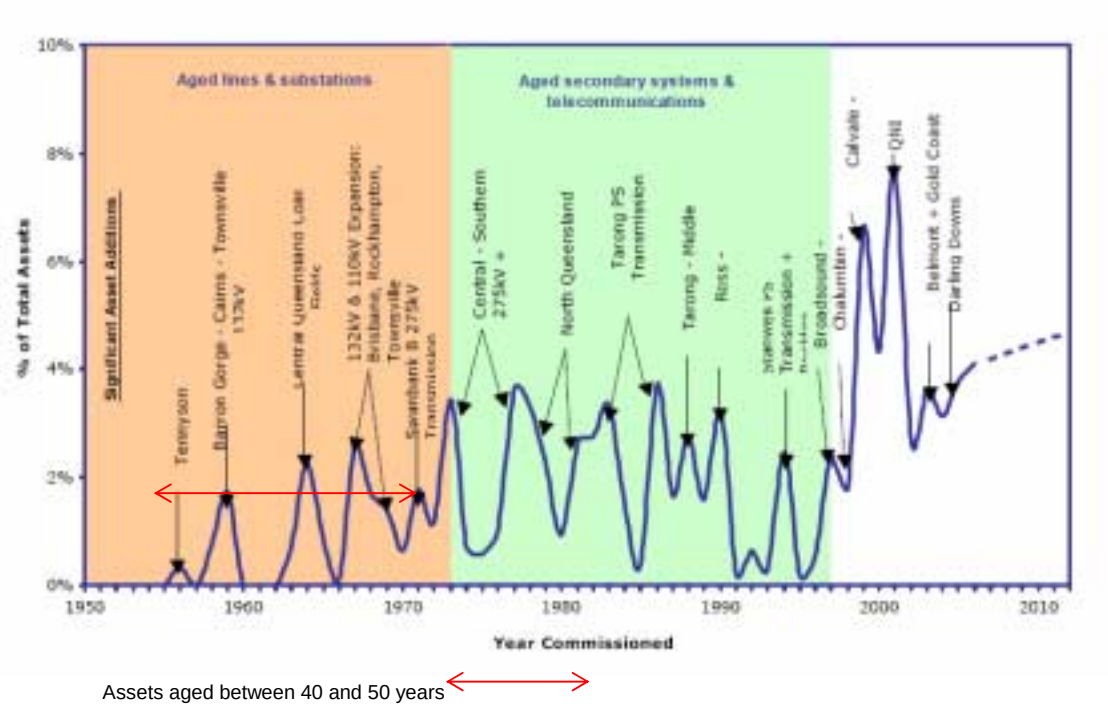
Augmentations are subject to Regulatory Test, but the submission does not indicate whether these projects are likely to pass Regulatory Test. Supporting spreadsheets shows that the Regulatory Test has been carried out on only about $300M of projects (13% of the submitted budget).

To determine that Powerlink has estimated the correct level of project expenditure, more details of cost breakdown should be supplied for a sample of projects, including information on whether each project would meet the regulatory test

2.5.3 Asset Replacement

Replacement Capex of approximately $800M on RAB of $3,266M equates to approximately 25% of the value of the network to be replaced. Transmission assets have an average life of between 40 and 50 years. This equates to assets installed prior to 1970 to be considered for replacement. However, from the age profiles shown on p. 69 of Powerlink's submission and in Figure 2-4 below, this proportion appears to be lower than the 25% discussed above. It would be considered prudent to obtain more details on the proposed assets to be replaced.

Figure 2-4 Assets facing replacement in the coming regulatory period



An asset management strategy has been supplied with the submission but limited details of the replacement projects have been supplied. More details are required to determine that appropriate levels of expenditure have been applied.

2.5.4 Cost Increases

Powerlink has not provided any indications of whether unit costs are in line with industry practice, in particular ensuring that specifications and construction standards compare to good industry practice within the rest of Australia.

The application notes that wages and material costs have increased significantly, and that this accounts for a large proportion of the overall capex increase sought. However, the range of cost increases highlighted in the submission is around 10%, with a worst case of 50%, which does not account for a required capex increase of around 100%. A breakdown

of the drivers for the increased capex, and their relative contributions, is needed to accurately determine this.

We do acknowledge that that material costs associated with transmission lines have significantly increased above the rate of CPI in recent years. In addition to this increased cost in materials, Queensland's power industry labour costs have increased due to large pay increases paid by ERGON and Energex. We, however, do not believe that these increases justify the almost 100% increase in capex sought.

The AER needs to determine:

- How relevant these cost increases are?
- Are they realistic?
- How would more competitive industries address similar increases in their costs?

2.5.5 Capex Benchmark

The ratio Capex to RAB has been used by the AER to benchmark across all TNSP on the same basis in its report Transmission Network Service Providers - Electricity Regulatory Report for 2004/05 dated April 2006. Based on the AER's 2004/05 regulatory report on TNSPs dated April 2006, Table 2-2 shows that in 2005, Powerlink has a CAPEX/RAB ratio of 7.7%. This is the highest in the NEM except for Transend (comparisons with PowerNet/VENCorp have been omitted due to the different nature of the Victorian Transmission arrangement). Of even greater concern, however, CAPEX forecast provided by Powerlink indicate that this ratio is expected to increase to over 14% in the first two years of the next regulatory period.

This ratio provides a measure of the amount of investment per unit of asset base. Using replacement cost rather than RAB may be a better measure. However, there is no reliable replacement values published for all TNSPs. We also believe that even if replacement values were used, the relative standing of the TNSPs would not be significantly different and the magnitude of the difference would not be significant unless the assets are of significantly different vintages. In any event, we are benchmarking the ratio across TNSPs and over time, not comparing capex to the asset base for any particular TNSP.

We recognise that the high growth rates experienced by Powerlink would tend to increase this ratio. However, we do not believe that this can fully explain why the ratio increases from 7.7% in 2005 to over 14% in 2008 and 2009. Demand growth has been high in Queensland since around 2000. Between 2000 and 2006, demand growth averaged at around 5.5% pa. Based on NEMMCO's 2005 *Statement of Opportunities*, demand growth is forecast to fall to around 3.7% pa from 2007 onwards. The growth in demand thus cannot explain why the Capex/RAB ratio should double when demand growth is expected to moderate. This is a point that requires detailed questioning and assessment by the AER.

Table 2-2 Comparative CAPEX vs RAB ratio

Capex/RAB %	Actual				Forecast				
	2003	2004	2005		2008	2009	2010	2011	2012
ElectraNet	4.2	4	6.1		5.5				
EnergyAustralia			6		9.1	6.7			
Powerlink	8.1	6.2	7.7		14.4	14.3	12.0	12.3	11.5
Transend		9.5	8.3		6.5	5.4			
TransGrid	9.3	8.3	3.8		11.5	9.6			

A comparison with previous ACCC decisions for other TNSPs has also been provided in Table 2-2 for the forecast period. If the proposed Powerlink capex program is approved without amendments, Powerlink will have the highest level of investment relative to the asset base of all NEM TNSPs by a considerable margin.

2.5.6 Capex efficiency savings

Powerlink claims to have identified several instances of management induced capital efficiencies, especially the reinforcement of supply to the Gold Coast through the early acquisition of easements and proposes that these savings be shared on a 50/50 basis with customers. While customers are not averse to the sharing of benefits as a result of genuine savings due to management efficiencies, the Gold Coast example cited seems to indicate that the savings may have been more fortuitous than due to management efficiency. Obtaining an easement some years prior to it actually being required by itself may, in fact, be considered inefficient. That land prices have increased in the meantime is simply fortuitous and anyone who had owned land in a major Australia metropolitan area in the last five years could not have failed to enjoy similar fortune. We are also mindful that the cost of carrying the easement for the time between its acquisition and its requirement have been met by customers. Customers thus remain to be convinced that these savings are a result of Powerlink's management efficiencies. Unless the AER is convinced that these savings are the result of management efficiencies, the full cost savings should be immediately passed through to customers.

3 OPERATING AND MAINTENANCE EXPENDITURE

3.1 Historical Opex

In November 2001, the ACCC approved Powerlink's O&M expenditure amounting to inflation adjusted $474M over the six year period from 2001/02 to 2006/07. Over this period, Powerlink's actual opex is estimated to be over $510M, $36M greater than the ACCC allowed amount. Almost all of the difference is accounted for in the second half of the current regulatory period.

Of even greater concern is the fact that the gap between the ACCC approved amount and the actual opex amount that Powerlink spent has been increasing. Powerlink claims that this overspend is due to various external factors including:

- Increasing labour costs;
- Increasing legislative obligations including changes in safety legislation and the Vegetation Management Act; and
- Growth in its network.

While we do not doubt that Powerlink faces some cost pressures, all enterprises in the economy face similar ones. Nevertheless companies in a competitive environment cannot simply pass on their higher costs by increasing prices. Cost increases must be addressed by productivity gains and improved efficiencies. The alternative is loosing market share and reduced profits. It is only when productivity gains and efficiencies are greater than cost increases that enterprises would enjoy improved returns. If Powerlink cannot find sufficient productivity gains and efficiencies to offset its operating costs, then its returns should similarly suffer.

Is this not what "incentive regulation" is meant to promote – the incentive to find efficiencies and achieve productivity gains so as to improve returns?

Enterprises in a competitive environment cannot turn to a price regulator to increase prices to maintain profits in the face of cost pressures.

Figure 3.1 and Figure 3.2 shows Powerlink's opex over the current and next regulatory periods.

There seems to be a trend appearing in regulatory price reviews that, in the initial years immediately after a price review decision is made, operating costs are lower or in line with the regulatory decision. However in the later years, these costs seem to invariably increase to justify the higher expected expenditure in the next regulatory period. Is this an indication of the "regulatory games" that regulated businesses are playing? The AER should be aware of this trend and take steps to prevent any attempts to game the regulatory process.

3.2 Future Opex

As with the capex forecast, details of labour and materials costs increases have not been provided. The discussion in section 2.5.4 relating to the significant increases in material and labour costs also relates to operating expenditure.

Specifically:

- The Revenue Proposal discusses in qualitative terms the need to increases wages to close the gap with southern states. However, no specific details of the size of wage increases is provided, nor benchmarking/comparison of wage costs increases relative to comparable Queensland businesses.
- Discussion of the need and justification for opex increases is largely qualitative, with insufficient detailed analysis to enable judgements to be made on the quantum of increases sought. More detail is required to assess the reasonableness of the actual quantum of opex increase sought.

Over the next regulatory period, Powerlink has forecast that average annual opex would be over 65% ($56M) greater than the average annual opex in the current regulatory period. This is shown in Figure 3.1. Compared with the opex approved by the ACCC for the current regulatory period, the average annual increase is almost 80% or $62M. Over the regulatory period, in trend terms, Powerlink's proposed opex increase over the opex projected from the ACCC's previous decision is some 33% or $176M. Even when compared with the trend projection from its actual historical opex, the proposed increase amounts to about $74M (12%). This comparison is shown in Figure 3.2.

Increases in opex of the magnitude sought by Powerlink needs to be examined closely by the AER and pared back significantly to reasonable and efficient levels before consumers would accept it as reasonable. Application of techniques such as benchmarking, external assessment of proposals, comparisons with past trends, detailed examination of the explanations, reasons, or claimed sources of cost pressures and the like are required.

Once again, the AER needs to determine:

- How relevant these cost increases are?
- Are they realistic?
- How would more competitive industries address similar increases in their costs?

3.2.1 Increase in Opex due to Network Growth

Previous SKM studies have indicated there are economies of scale in opex related to the size of the network. These studies indicate that opex should increase by no more than 75% of the relative increase in the size of the network. Based on an augmentation capex of $1,222M on an existing RAB of $3,266M equates to an increase in the size of the network

by some 37%. On this basis, an opex increase of 28% is explained by the growth in the network. The 65% average increase cannot be explained solely by network growth.

Figure 3.1 Powerlink's Annual Average Opex

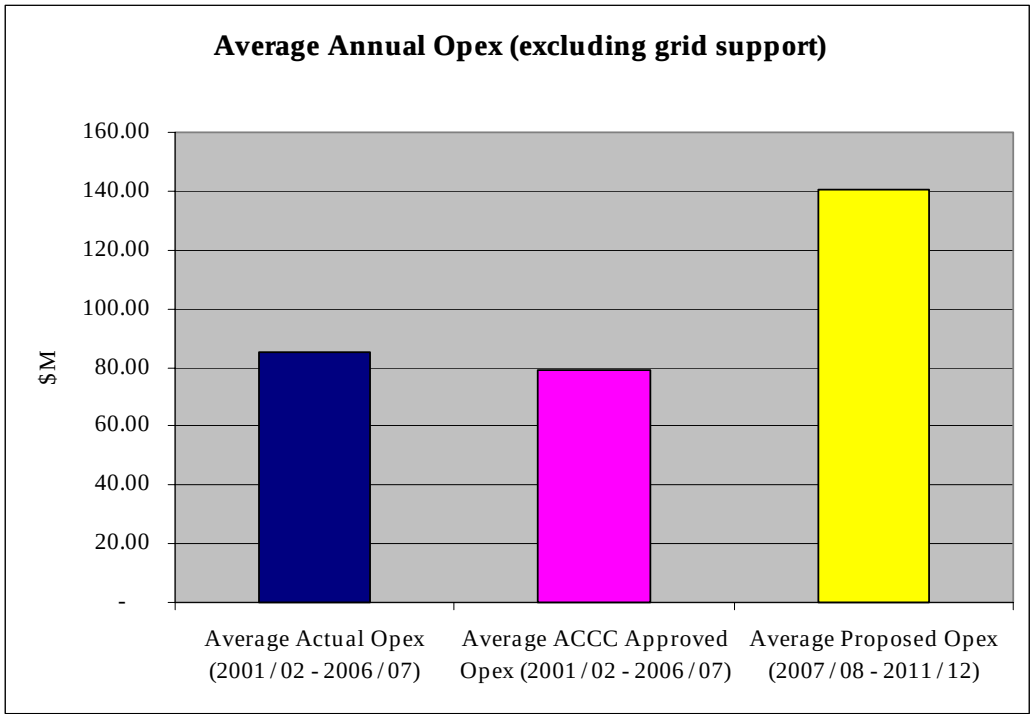
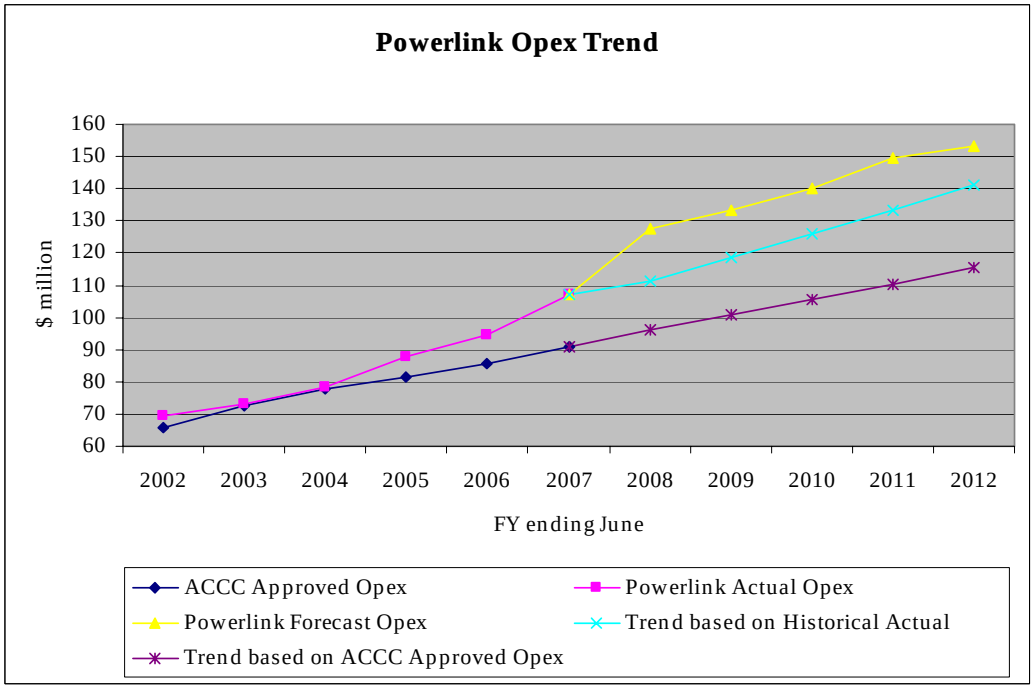


Figure 3.2 Powerlink's Opex Trend



3.3 Direct Operating and Maintenance Cost

Direct Operating and Maintenance costs account for the largest proportion of Powerlink's opex requirements. These costs have been broken down into 3 key components:

- *Field maintenance* – consists of preventive and corrective maintenance of assets from post-commissioning to decommissioning. The key drivers for this element of expenditure are labour, materials, size and type of network. Powerlink have indicated that the increases in costs are associated with labour, maintenance techniques, materials and parts. It is unclear from the narrative the magnitude of these increases and whether these increases are in line with other businesses with the same cost drivers.
- *Operation refurbishment* – activities that return an asset to its pre-existing condition or function. Cost drivers for operational refurbishment are the type of assets and the age profile of the assets, both of these elements will relate to labour and materials costs. As with the field maintenance, Powerlink has indicated that the labour and materials components are the key reasons for increasing operational refurbishment but, as with the field maintenance, no details of these increases have been supplied.
- *Network monitoring and control* - Powerlink has indicated that, due to increases in size and complexity to the network, additional resources and capabilities will be required. However, no details of increases to existing labour force have been included within the submission.

A breakdown of the drivers for increased opex, and the relative contribution of each driver, would be informative. Specific changes to vegetation management, safety, environment, and operational practices, and the associated impact on opex costs, should also be clarified.

The absence of these details make it very difficult for us – and we would assume the AER – to undertake a rigorous analysis of Powerlink's claims.

3.4 Opex/RAB

Powerlink claims that its opex/RAB ratio for 2004/05 is 2.46%. Over the forecast period, Powerlink states that it expects this ratio to fall to 2.13%.

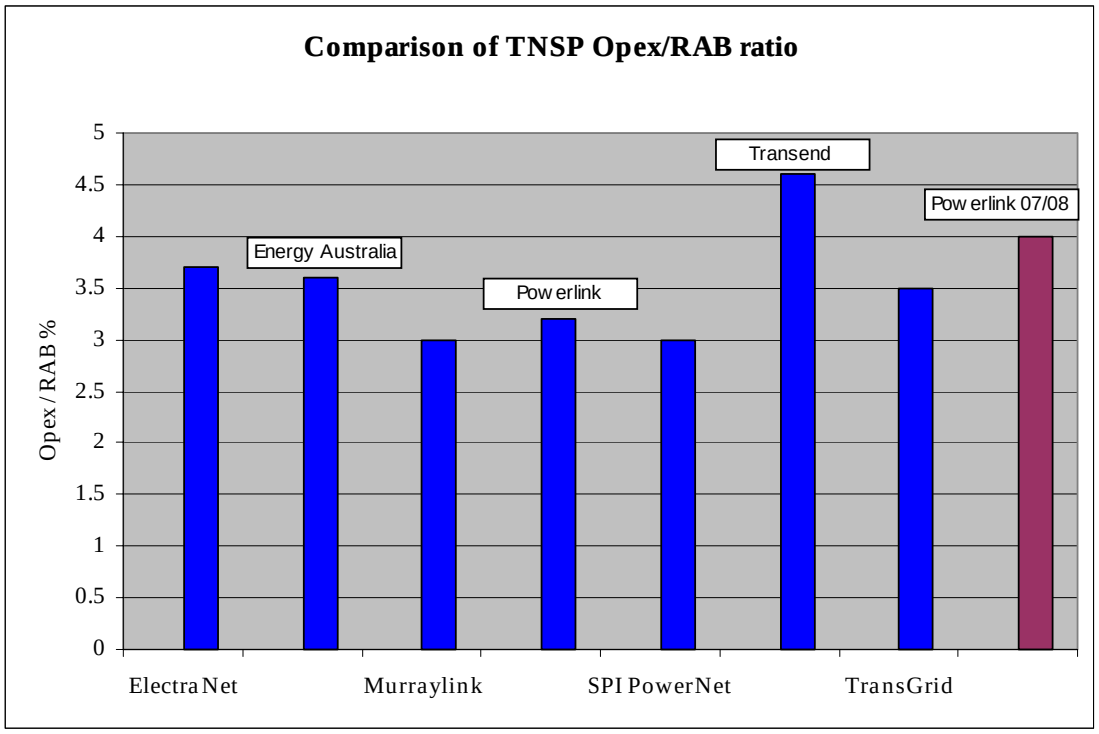
Based on numbers in Powerlink's revenue proposal, historical opex/RAB was 3.1% between 2001/02 to 2003/04, 3.3% in the following two years and 3.6% in the final year of the current regulatory period. Based on its forecast opex and RAB, in 2007/08, opex/RAB will be 3.4% after removing the cost of grid support. This analysis is shown in Table 3-1.

Table 3-1 OPEX vs RAB ratio (excluding Grid Support)

		2002	2003	2004	2005	2006	2007	2008
Opening RAB	$m	2276.9	2394.4	2553.7	2682.8	2856.8	3011.4	3796.5
Powerlink Opex	$m	69.7	73.2	78.3	87.5	94.8	107.0	127.7
Opex/RAB	%	3.1%	3.1%	3.1%	3.3%	3.3%	3.6%	3.4%

Based on the AER's April 2006 regulatory report on TNSPs, Powerlink's opex/RAB ratio of 3.4% in 2007/08 would only put it equivalent to the average of the NEM TNSPs and slightly poorer than average if we exclude Transend, which has an extremely poor opex/RAB ratio. If we were to include the cost of grid support, Powerlink's opex/RAB ratio would amount to 4%. Powerlink's claim that it is "the most cost-effective transmission entity in the NEM" does not appear to bear up to close scrutiny. Figure 3.3 shows the Opex/RAB ratio based on the AER's 2006 regulatory report together with Powerlink's Opex/RAB ratio for 2007/08.

Figure 3.3 Comparison of TNSPs Opex/RAB ratio



3.5 Demand Management and Grid Support

We commend Powerlink for its efforts in investing in a number of non-network solutions in meeting reliability and peak demand requirements. In the past, we have often seen TNSPs (and DNSPs) pay lip service in wanting to acquire DSM only to provide excuses regarding the difficulties of obtaining such resources.

We, however, are disappointed to see that there is little evidence in its Revenue Proposal to address any additional demand management and embedded generation opportunities and embed this in its business strategy for the next five years.

We understand from our contacts with the industry in Queensland that there are significant opportunities to defer future capex with demand management/embedded generation.

Exploiting these opportunities more effectively would allow Powerlink to better manage some of the cost pressures and avoid the pass through of the high cost of capital to all Queensland users.

We note that the benefits of embedded resources on a $/kWh avoided are greater when networks are exposed to short duration and infrequent peaks that are typical of extremely hot days. However, this in not to say that there are not still significant opportunities and Powerlink's own success in the past is evidence that they exist.

While we acknowledge that there may be some issues with how the system can ensure that such non-network alternative will be available during times of system stress, more needs to be done to encourage a solution which will lead to an overall lower cost.

That network operators' revenue is dependent on network expansion, in large part because of the incentives in the current regulatory regime, is a significant impediment to the development of demand side response even though such development would almost certainly lead to lower overall cost.[8] Based on our experience and exposure to these matters over time (in both transmission and distribution), it is also our view that there are certain significant ways in which non-network solutions do not encounter a level playing field. This includes inadequate notice periods of potential opportunities to allow non-network solutions to be developed, a lack of information about opportunities, a lack of direct contact and interaction with potential providers of demand side response (eg end users, retailers and aggregators), a lack of players with the ability to co-ordinate such options, a lack of end-user knowledge and education, and other factors. (We note the Powerlink has generally been one of the more proactive TNSPs in this area, but this is not say that it can't do more in future.)

Attention to all these issues is needed. However, it would be unfair and inappropriate for individual TNSPs to be left with the sole responsibility for this. Policy makers, regulators, retailers, customers, aggregators and bodies such as the EUAA all have a role to play. Regulatory measures to encourage Demand Management and aimed at providing NSPs with sharper incentives to peruse non-network options and aggregation providers (such as Energy Response), are all worth serious consideration and should be encouraged by the

[8] It is also clear from our discussions on the matter that network solutions, especially in sensitive areas, can create a plethora of planning, technical, infrastructure, environmental regulatory hurdles that can delay construction and increase costs.

AER's regulatory decisions. This applies even more so in Queensland, given the high growth in peak demand being experienced and the associated impact on capex and opex.

4 WEIGHTED AVERAGE COST OF CAPITAL

Return on capital (WACC X Asset Value) accounts for over 62% of Powerlink's annual revenue requirements over the next regulatory period. This always provides strong incentives for ambit claims and exercise of 'strategic behaviour' by regulated entities during regulatory reviews (i.e. gaming of the process, setting of parameters and associated information). A 50 basis point difference in WACC results in an approximately $120M change in revenue for Powerlink over the five year regulatory period.

We provide some comments on specific components of WACC in the following sections.

4.1 Risk Free Rate

In the SRP, the AER proposes to estimate the risk free rate with reference to the 10-year bond rate. This proposal, however, ignores the fact that refinancing of debt can readily be undertaken in a financially mature market like Australia. Given the five yearly regulatory cycle, it is more appropriate for 5 year bond rates to be used as refinancing can occur to coincide with the regulatory cycle. Over the long term (October 1993 and April 2006), 5 year Treasury Bonds average about 28 basis points (bp) lower than the 10 year bond[9]. Recently (January to April 2006) however, the difference between the two yields is just 3 bp. Nevertheless, using 5 year bond yields can be expected to lead to a slightly lower WACC. There is no reason why the bond yield period should be different from the regulatory period under consideration.

4.2 Market Risk Premium (MRP)

Powerlink uses the MRP prescribed in the SRP at 6%. The AER, however, should be aware that customers have never agreed that 6% is an appropriate MRP value. Customers have always contended that a 6% MRP is based on backward looking historical data, which tells us what the MRP was in the past but may have little relevance to how markets might behave in the future in the presence of significantly lower inflation and interest rates. We note that whilst other WACC parameters are forward looking, the estimation of the MRP remains the only WACC parameter that still relies on backward looking historical trends.

The AER should note that UK regulators have all adopted a forward-looking market view in estimating the MRP. UK regulators adopt substantially lower values for the market risk premium (of 3.5% - 4.0%) than do Australian regulators, who all adopt values around 6.0%.

In its SRP Discussion Paper, the ACCC stated that it believed that this difference is due to segmented stock markets, and that investors require a higher risk premium to invest in

[9] http://www.rba.gov.au/Statistics/OP10_update.xls

the Australian market. We, however, see no evidence of this segmentation, neither of stock markets nor of investors requiring a higher risk premium in Australia. Indeed, while there is evidence that debt costs are different (and this is taken into account by the risk free rate and debt premiums), there is no evidence that Australia is not fully integrated into competitive international debt and equity markets. We thus do not see any evidence that financial markets see Australian utilities as being 'less efficient' or 'more costly' than their UK and US counterparts, particularly when other capital-intensive (but unregulated) Australian companies are able to compete internationally for capital and debt funding.

In its report for the Electricity Consumers Coalition of South Australia, *Further Capital Market's Evidence in Relation to the Market Risk Premium and Equity BETA Values*, dated December 2003, Headberry Partners and Bob Lim & Co found that the average MRP over the period 1970 - 2001 is 3.30% (as measured against 5 year bonds) and 3.03 (measured against 10 year bonds). Inflation over the same period averaged 3%.

Recent regulatory decisions using an MRP of 6% grossly inflate the returns on equity above the level required by the market. Australian regulators should consider adopting a forward-looking MRP value, as implemented by overseas regulators, which would also be more consistent with the methodology applied in determining the other WACC parameters.

4.3 Equity Beta

Powerlink also propose an equity beta of 1.0 consistent with the SRP. Again customers do not accept that an equity beta of 1.0 is appropriate for a regulated monopoly with guaranteed level of revenue.

By definition, the market as a whole has an equity beta of 1. Applying an equity beta of 1.0 for a regulated monopoly with guaranteed level of revenue implies that the AER believes that TNSPs are as risky as the market as a whole. This is incongruous when 99% of its revenue is guaranteed and total compensation for its costs of service assured by the regulatory arrangements. We cannot emphasis strongly enough that there is no risk in this business!

Accordingly, the equity beta should be significantly less than one.

This position is supported by the Allen Consulting Group which, in its report to the ACCC, *Empirical Evidence on Proxy Beta Values for Regulated Gas Transmission Activities*, dated July 2002, suggested an equity beta of under 0.7 for Australian gas transmission companies based on Australian market data.

Prior to handing over its energy responsibilities to the AER, the ACCC had also suggested that it was willing to consider equity betas as low as 0.35 (see discussions on the draft

Statement of Regulatory Principles[10]). In addition, we note that the ACCC agreed in the GasNet case before the Australian Competition Tribunal that an equity beta of 1 was overly generous. That the ACCC had chosen to ignore its own consultant's advice and its own research into this matter in its past decisions is regrettable and has imposed additional cots on consumers.

We note the ACCC statement in its Final Decision on Transend's transmission revenue application indicated that in future regulatory decisions it would incorporate equity betas, which reflect market information more accurately[11].

We urge the AER to use the Powerlink determination to place a 'line in the sand' on this matter and show that it will be setting equity betas in its regulatory decisions that match reality, that is, they recognise the low risk nature of TNSPs and are set at substantially less than unity.

4.4 Debt Margin

In its Revenue Proposal, Powerlink is proposing a Debt Margin of 1.1%. This is around 20 basis points higher than debt margin the ACCC allowed for TransGrid, EnergyAustralia and Transend (its last three major transmission revenue determinations). Even Directlink which operates only the interconnection between NSW and Queensland in competition with QNI received a debt margin of 1%. We find it difficult to believe that debt providers would see Powerlink as a more risky proposition than Directlink.

As Table 4-1 shows, since October 2003 after the last Powerlink revenue determination, the ACCC had set debt margins at no more than 1%. All the decisions other than Directlink have been around 0.9%. The credit ratings for these TNSPs are also comparable to Powerlink. Thus, in our opinion, there is no justification for Powerlink to have a debt margin greater than 0.9%.

Table 4-1 Comparative Debt Margins

ACCC's Decision	Credit Rating	Debt Margin	Date
ElectraNet	BBB+	1.22%	Dec-02
PowerNet	A+	1.20%	Dec-02
Powerlink	A-AA	1.20%	Dec-02
Murraylink	A	0.86%	Oct-03
Transend	A	0.91%	Dec-03
EnergyAustralia	AA	0.87%	Nov-05
TransGrid	A	0.90%	Nov-05
Directlink	A	1%	Mar-06

[10] ACCC *Discussion Paper, Review of the draft Statement of Principles for the Regulation of Transmission Revenues*, 2003,p.78

[11] ACCC, Tasmanian Transmission Network Revenue Cap 2004-2008/9: Decision, 10 December 2003

5 SERVICE STANDARDS AND PERFORMANCE INCENTIVE

Consumer groups believe that it is important that electricity users obtain a reasonable level of service from the transmission system. We welcome steps taken to require TNSPs to implement some (limited) service standards, but believe that further steps are needed to establish a more effective and meaningful system of incentives for service.

The AER should be aware of our strong views on the need for regulated transmission entities to be provided with incentives or service standards, particularly related to the impacts on the energy market (for example, due to outages for scheduled maintenance). This is axiomatic given the large impact, relative to transmission costs, that the actions of transmission companies can have on energy prices and their risk premiums.

We have also previously recommended that performance incentives for transmission entities would be more effective if applied uniformly across the NEM. Completing reviews and revenue re-sets for all regulated TNSPs at the same time would best do this. This highlights once again that the current arrangement of piecemeal review of individual TNSPs at different times is costly, inefficient and substantially reduces the benefit to end users of regulation. The benefits we see in aligning the regulatory review includes:

- Enabling better benchmarking of cost and performance
- Consistent service standards for all TNSPs
- Consistent with MCE's desire to have a common regulatory standard across jurisdictions
- Avoid some of the costs of conducting individual reviews

We urge the AER to ensure the alignment of regulatory reviews for all TNSPs to be undertaken at the same time.

Traditionally, TNSPs have achieved fairly high reliability levels. Consumer complaints regarding reliability are largely directed at distribution networks rather than the transmission system. This has been especially pronounced in Queensland where recent failures at the distribution level has been well publicised. However, an area where the transmission system has a significant impact is the effect planned and forced transmission network outages have on the pricing of energy in the wholesale electricity market. Inappropriately timed outages on the transmission system could significantly affect energy prices in the various energy market nodes leading to increased risk faced by retailers (and consumers). This results in a higher premium charged to consumers as retailers seek to cover their exposure through higher cost one way hedge products. Accordingly, effects of transmission outages on the wholesale electricity market should be taken into account in assessing the performance of TNSPs, including Powerlink.

The AER needs to resolve this question of outage scheduling as a matter of priority. While there seems to be two sides to this debate; one advocating the predictability of outage scheduling and the other promoting outage scheduling in response to spot pool prices, is it not possible that a combination of both positions may produce the best result? That is, outages may be scheduled on a number of option dates, with the final decision made in response to forecast spot pool prices in the pre-dispatch or reserve margins in the short-term PASA.

In its previous five revenue cap decisions (PowerNet, ElectraNet Transend, EnergyAustralia and TransGrid), the ACCC has placed 1% of allowed revenue at risk for under performances. This implies that 99% of the TNSP's revenue is guaranteed regardless of the level of performance. In the extreme event that Powerlink's performance deteriorates dramatically, consumers are still required to fund 99% of the allowed revenue.

Clearly the commercial financial incentive of placing just 1% of revenue at risk is not going to provide a strong incentive.

That the 99% of full revenue is achieved by just meeting the average historical performance level shows just how much the regulatory framework protects the TNSPs. In the normal competitive environment that most of Powerlink's consumers operate in, just meeting the average historical performance level would not guarantee past market share. Enterprises in a competitive economic environment must constantly improve their performance just to maintain their position. Only when its performance improvements are greater than its competitors would an enterprise begin to enjoy growth in revenues. Incentive regulation is meant to mimic the competitive market place and the AER needs to apply this competitive discipline to the businesses it regulates.

In previous decisions, the ACCC had structured its performance incentive scheme to achieve "revenue neutrality", whereby the TNSP's revenue over the regulatory period would be largely unaffected should the TNSP meet its historical performance levels. Consumers, however, would expect that, with consistently increasing capex and opex, TNSP's performance would generally be improving. As a result, the performance incentive scheme would serve to provide up to a 1% increase in revenue to the TNSP on the back of investments that consumers are already paying for, with little downside. Meaningful "stretch factors" need to be applied to ensure that consumers are not simply paying an incentive bonus for the better performance that the increased investments would, in any event, bring.

It has also been suggested that 1% of revenue equates to 5% of opex. We fail to see why this is significant. Taking an extreme example, in a new network, opex would be very low as new assets do not require any significant levels of maintenance. Hence, 1% of revenue could equate to a very significant proportion of opex. This, however, does not mean that

it provides any more incentive for performance. It still means that the maximum risk faced by TNSPs amount to 1% of its revenue. By any measure, this is not very much!

6 COST PASS THROUGH

In its application to pass through to consumers cost increases associated with:

- A Change in Taxes Event;
- An Insurance Event;
- A Service Standard Event;
- A Terrorism Event; and
- A Grid Support Event.

Powerlink has considered these events as exogenous and states that it has no control over of them.

Changes in taxes and insurance events unless they are specific to the electricity transmission and distribution sector will be experienced by all businesses. No pass through allowance should be made for such changes. Exogenous events affect all businesses – this is an inherent risk of operating in a competitive market place. Regulated businesses are compensated for undertaking this risk by achieving returns above the risk free rate in the WACC and are reflected in the market risk premium and beta values in particular. It is therefore unreasonable for consumers to have to pay the higher WACC as well as bear the risk that the higher WACC was meant to compensate. Regulators should not allow regulated monopolies the luxury of double-dipping.

Customers also have some expectations that Powerlink should seek to minimise insurance costs and grid support costs in their negotiations with suppliers. The AER will have to implement measures to ensure that this occurs as the existence of any pass through provision would remove any incentive for Powerlink to minimise these costs.

The AER should also ensure that regulation is a proxy for competition when dealing with monopoly network service providers. In considering pass through applications, the AER should ask itself the question, “How would a business in a competitive environment behave when confronted with an exogenous cost increase?”

We often see companies absorb large cost increases to achieve a competitive advantage. As mentioned earlier, Virgin Blue resisted passing through the cost of higher oil prices to airfares, despite Qantas, its only competitor, imposing a fuel levy. Businesses in a competitive environment do not pass through cost increases unless absolutely necessary as doing so could erode a competitive advantage. This normal competitive behaviour, however, seems lost on regulated network businesses as they do not experience any such pressures. It is time regulators apply the disciplines of the competitive market place on monopoly network service providers.

Moreover, we question if all these events are truly beyond the control of Powerlink. To some extent, Powerlink may have ability to influence to cost of some insurance events and grid support events even if a change in tax or service standard may be imposed by a political or regulatory authority. As a Government-Owned Corporation, Powerlink would presumably also have a greater ability to influence such outcomes.

Customers are also concerned with the definition of a "Terrorism Event" and would need a tight definition so that loosely related events cannot be construed as a reason for the pass through of cost increases.

We also note that Powerlink has already included the cost of self insurance into its opex requirements and thus question the need for cost pass through of such events when customers are already expected to pay the insurance costs.

In a related issue, Governments have recently required NSPs to implement increased security to prevent terrorist attacks on electricity infrastructure. We believe that the costs of increased security measures should be paid by the Governments seeking them. Powerlink should therefore seek compensation from Governments.

Should any pass through events be accepted by the AER, customers would expect that the AER also ensure that cost reductions are also passed through to customers. Simply depending on Powerlink to inform the AER and customers that costs for these events were lower than expected are not sufficient. The AER needs to consider that regulated businesses, such as Powerlink, will have little if any incentive to draw such matters to the attention of the regulator and end users are not in a well informed enough position to do so. Recently, customers have seen insurance premiums fall (after the increases following the collapse of HIH). We, however, have not seen any pass through of these insurance premium reductions in the form of lower TUoS charges.

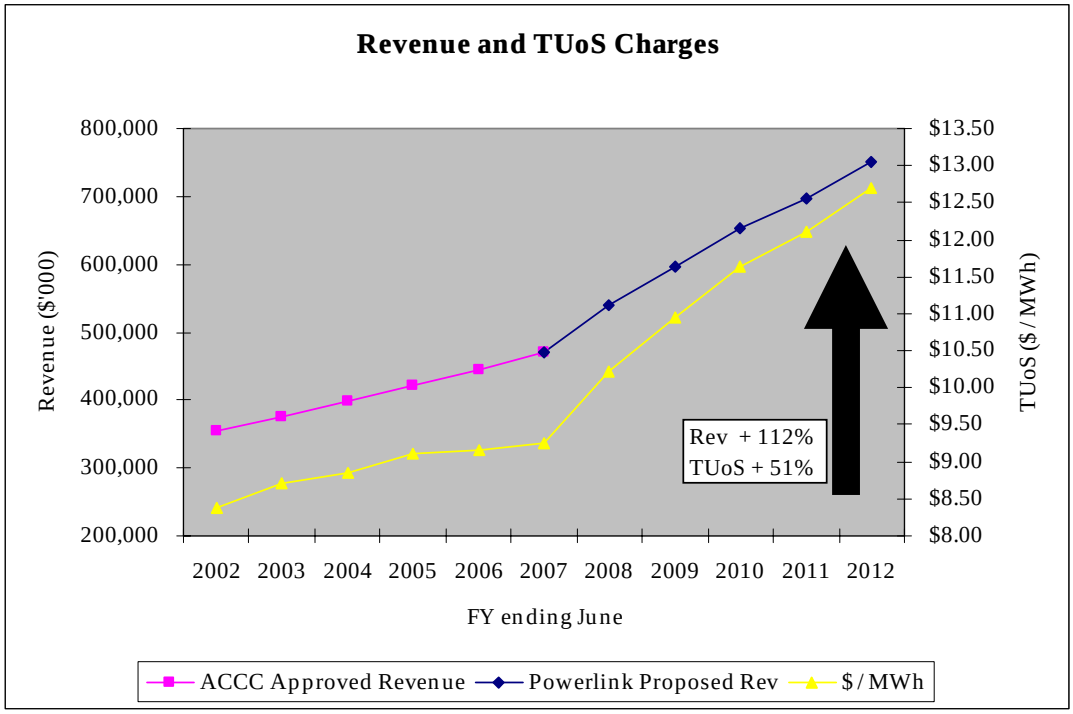
7 CUSTOMER IMPACT

7.1 Average Transmission Prices

For consumers, the main impact of the AER's determination on this and every other transmission issue is what this application means for prices. Figure 7.1 shows the average transmission prices (real June06 $) that Queensland consumers pay for the delivery of electricity. Between 2001/02 and 2006/07 under the current regulatory period, consumers pay an average TUoS of between $8.35 and $9.25 per MWh at an average growth rate of around 2% pa.

Under the Powerlink Revenue Proposal, the average TUoS payable will increase from the $9.26/MWh (forecast 2006/07) to $10.22/MWh in 2007/08, a 10.4% increase in the first year of the next regulatory period. The increase will continue despite growth in energy demand[12] in 2007/08 of over 4% pa. In 10 years, average TUoS prices will have increased from under $8.40/MWh to $12.70/MWh, an increase of over 50%. Most of this increase (over 37%), as can be seen in Figure 7.1, occurs as a result of this application. This is despite having taken into account the actual and forecast growth in energy demand over the period.

Figure 7.1 Average Qld TUoS Charges



[12] Based on forecast GWh provided by NEMMCO in the 2005 Statement of Opportunities.

With average price increases of this order of magnitude, the AER must recognise the impact it would have on Queensland customers including EUAA members. The impacts on Queensland and Australian economic competitiveness when transmission prices increase by over 37% over the next 5-years must be taken into consideration in the AER's decision.

7.2 Business Performance

Figure 7.2 shows Powerlink's profit positions. Between 2001/2002 and 2004/05, Powerlink averaged an annual operating profit before interest, tax, and depreciation of around $306M based on its reported Grid Revenue in its various Annual Reports. This was in line with the average profit levels envisaged in the ACCC decision on Powerlink's revenue cap in 2001. Should its current application be approved, Powerlink's EBITDA will increase by over 72% to almost $590M in 2012 over the EBITDA reflected in the 2004/05 Annual Report.

Operating profits will increase by over 15% between the first two years (2007/08) and by over 9.5% pa in the remaining period. These profit growth rates are at least twice that achieved by projecting revenue and opex trends from the previous ACCC decision. By the end of the next regulatory period, should the application be approved, Powerlink's operating profits will have increased by a massive $122M if the trend from the previous regulatory period had continued. This is shown in Figure 7.2. EBITDA growth rates are shown Table 7-1.

Figure 7.2 Powerlink Earnings Before Interest, Tax, Depreciation and Amortisation

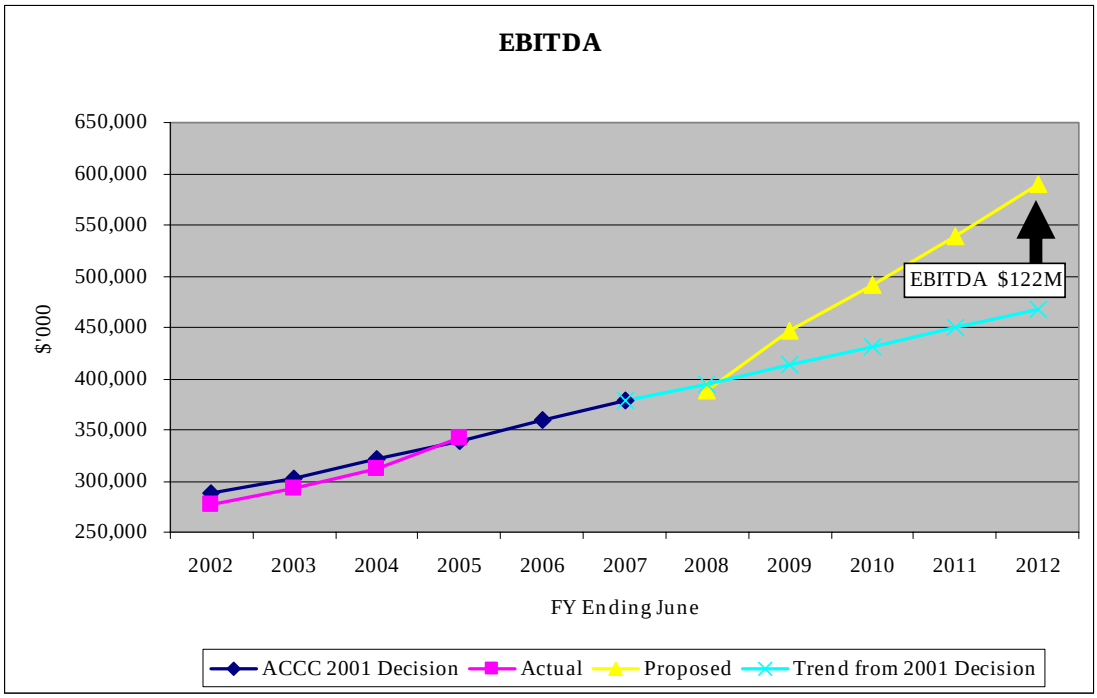


Table 7-1 Powerlink Earnings Growth

EBITDA	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
ACCC 2001 Decision	4.9%	6.0%	5.7%	5.7%	5.5%					
Actual	6.0%	6.5%	9.3%							
Proposed						4.3%	15.1%	9.7%	9.7%	9.5%
Trend from 2001 Decision	5.4%	6.4%	6.1%	5.8%	5.1%	4.3%	4.6%	4.4%	4.2%	4.0%

Between 2009 and 2012, Powerlink is proposing average earnings growth of 11% within a stable market structure. It is difficult to envisage that an enterprise in a stable mature competitive environment can experience this level of profit growth within a 5-year period through organic growth. With this level of projected profit, there is a risk that resources will be dissipated with reduced attention to cost management just because there would be so much more room to make errors of judgement and management without adverse consequences. Figure 7.2 and Table 7-1 are quite strong *prima facie* evidence that this submission has elements of an ambit claim.

7.3 Regulatory Framework

On a related issue, Powerlink and other TNSPs are generally regulated via a revenue cap. As such, these monopolies face little, if any, volume risk both in terms of energy, maximum demand, as well as consumer numbers. Should a consumer reduce electricity consumption due to lower production or closure of the business, all other consumers will have to pay more transmission charges to "compensate" for the reduced revenue. In the event that a consumer leaves (eg a mine ceases operations), the cost of transmission services for other consumers would rise accordingly to restore Powerlink's revenue target. Even if performance falls and the quality of its services deteriorates leading to a lower demand, Powerlink's revenue, under this regulatory arrangement, is assured with the transmission charges rising to compensate for the losses in volumes. This provides very little incentive for Powerlink to produce a quality product to retain consumers and maintain volume.

This contrasts to price caps faced by some distribution NSPs (eg in Victoria and New South Wales), whose regulated charges are based on average prices. These distributors at least face the prospect of lower revenues should volumes, demand or consumer numbers fall below forecast.