# Energy Infrastructure Investment & Regulation

Infrastructure Investment & Regulation Conference

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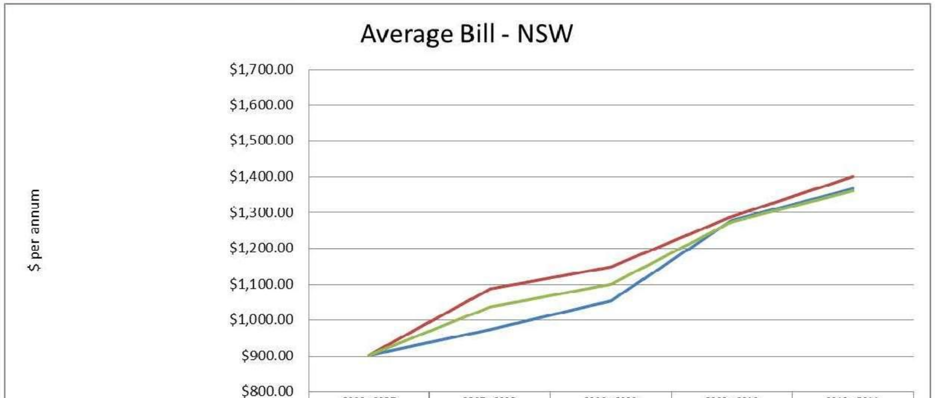
# Today's presentation

- Looking at the current drivers for the network businesses
- Some benchmarking
- Looking at what's changed over the past 15 years
- The AER Rule change proposals
- Information asymmetry
- UE and Multinet's view of the Rule change proposal
- What is needed to ensure confidence

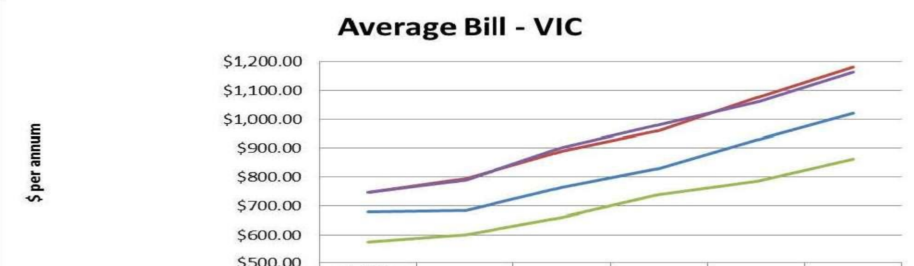
# Key Drivers

# Prices are going up

- Prices are on the increase – nationally
- There are many drivers – inc:
  - Rising retail/generation costs
  - Increasing reliability standards
  - Rapidly growing peak demand
  - Aging infrastructure
  - Network costs are part of the cause
- Customers are understandably concerned
  - Customers and some other commentators (including the AER) are not confident that:
    - Network pricing is efficient
    - Or the regulatory regime is working effectively




| | 2006 - 2007 | 2007 - 2008 | 2008 - 2009 | 2009 - 2010 | 2010 - 2011 |
|---|---|---|---|---|---|
| Average Bill - Baseline Usage | $903.28 | $973.81 | $1,054.43 | $1,278.19 | $1,366.11 |
| Average Bill - full pass through of cost stack increase | $903.28 | $1,088.13 | $1,149.16 | $1,290.29 | $1,400.73 |
| Average Bill - Actual Average Bill | $903.28 | $1,035.92 | $1,100.63 | $1,274.10 | $1,361.76 |




| | July 2006 - Dec 2006 (annualised) | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Average Bill - Baseline Usage | $747.36 | $794.74 | $889.16 | $959.38 | $1,072.71 | $1,180.54 |
| Average Bill - Actual Average Bill | $747.36 | $788.22 | $903.32 | $979.54 | $1,057.90 | $1,164.48 |
| Std Offer (4000KWh) - Excl GST | $678.18 | $684.55 | $762.73 | $828.18 | $928.18 | $1,020.55 |
| Lowest Market Offer (4000kWH) - Excl GST | $575.45 | $600.00 | $661.82 | $738.18 | $784.55 | $861.09 |

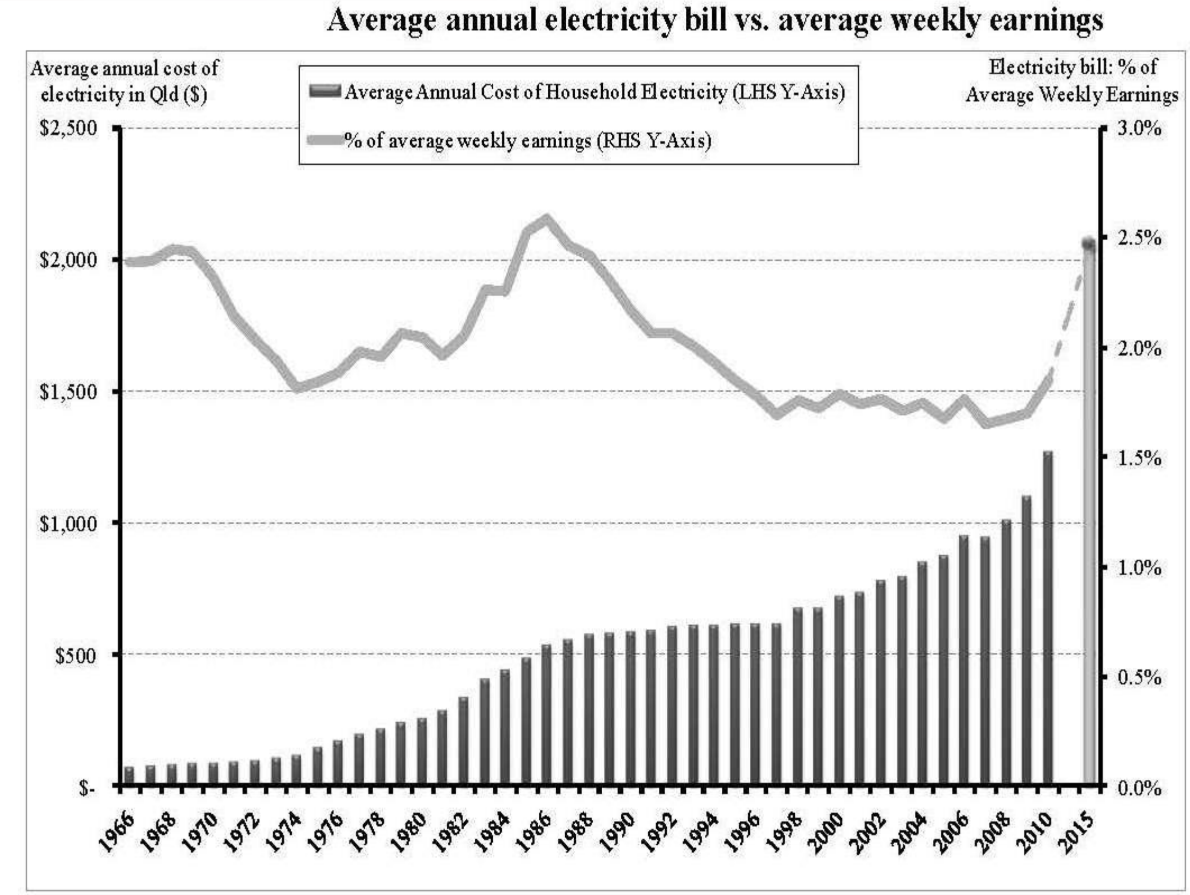
*NOTE 1: There is no "Average Bill - full pass through of cost stack line" for Victoria because for 2008 onwards, there is no cost stack line available.

NOTE 2: This graph also includes: (a) the standing offer (excluding GST) if a comsumer used 4000kWh, and (b) the lowest market offer (excluding GST) for that year based on 4000kWh.

Source: Oakley Greenwood

# Prices are moving from a low base

- Electricity as a % of weekly earnings
  - Returning to the levels they have been at twice before
- Prices have moved in cycles

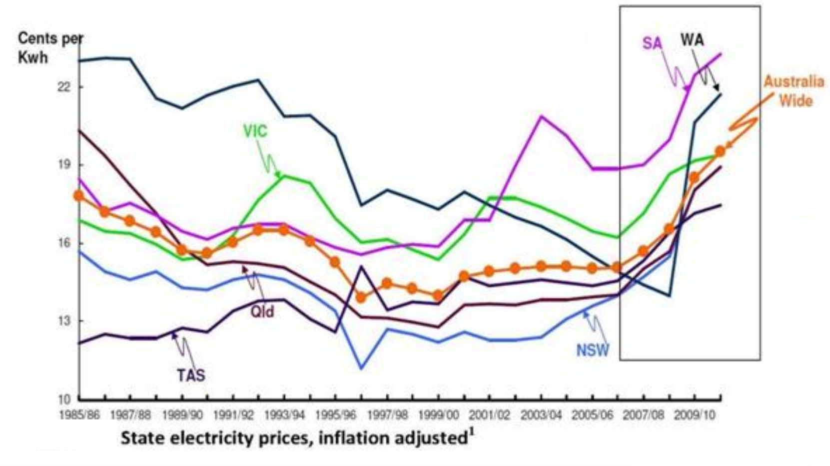



Source: esaa, ABS, AGL Energy Ltd.

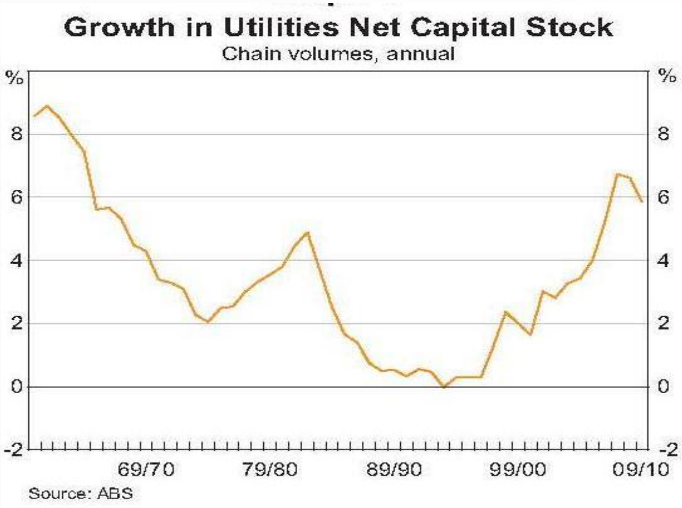
Note: Whilst this graph uses Qld data, the trends are similar nationally – see next slide

# Prices and investment have both moved in cycles

- Different issues have driven prices in the different states
- But boom and bust cycles have been common
- We are coming out of a low investment period during the 1990s
  - The problem is compounded as the assets built in the boom of the 1950s/1960s reach the end of their lives



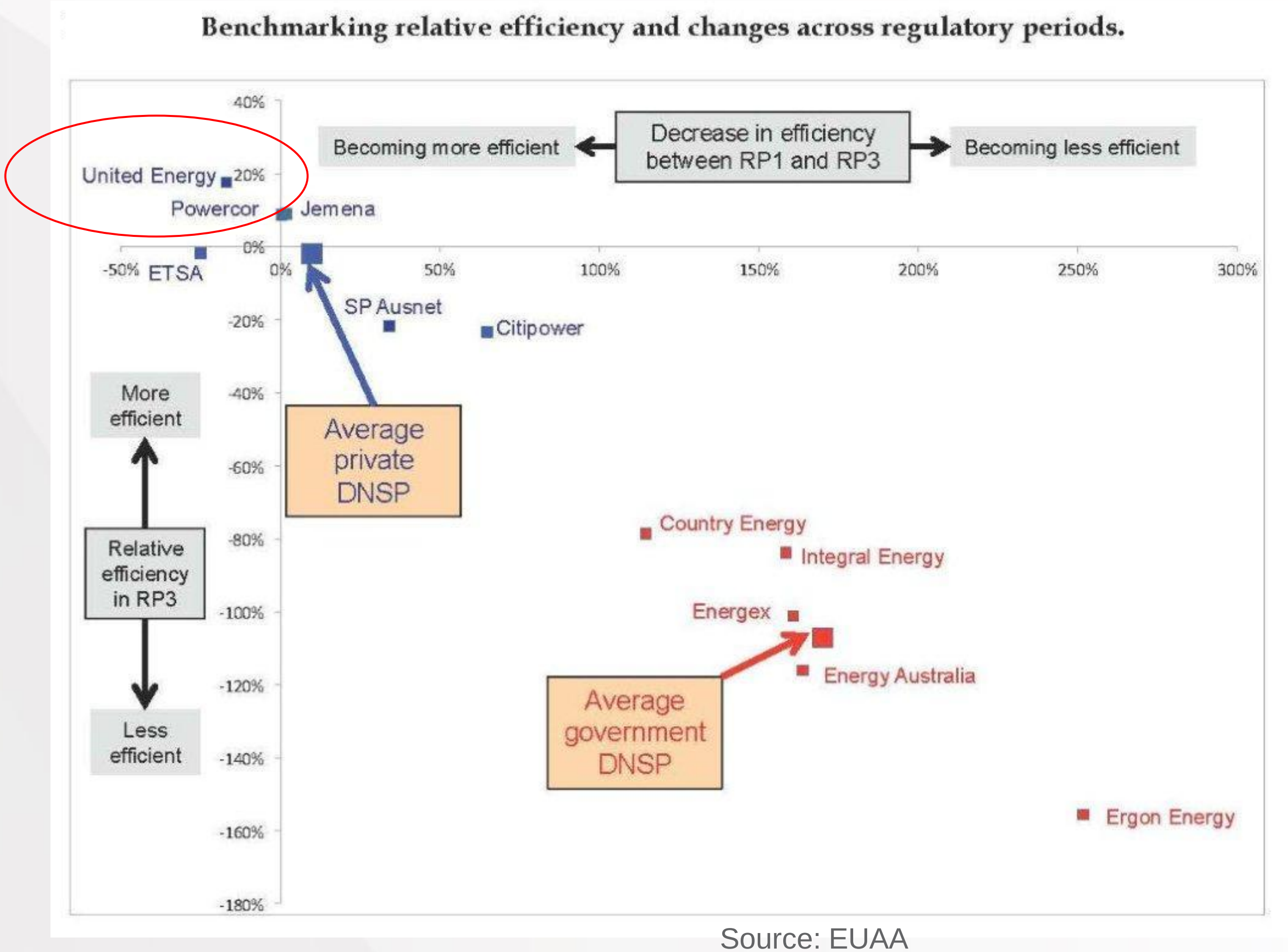

Source: Australian Industry Group



# Understanding the journey - 1990s to now: *United Energy as an example*

- Overall increase- 1990s: $50m pa of capex. Now: $180m pa.
- *Asset replacement:*
  - Of the $50m pa in mid 1990s, $10m was replacement capex
  - Given the size of the asset base at the time, this implied a 200 year asset life!
  - Asset replacement spend in the coming regulatory period implies a life of 100 years approximately
    - i.e. four times in nominal dollars, and two times in 'implied life' terms
- Peak demand growth *(Maximum Demand - MD):*
  - Peak demand is growing at 2.5% per year – 50 MW per year
  - At the same time consumption is not growing – 0% over past 5 years
  - This drives up prices as we build for the new MD, with no additional sales volume
- Asset Utilisation *(at MD):*
  - In the 1990s we introduced a range of schemes to greatly increase network utilisation, reducing the need to install new capacity at that time
  - But now utilisation has maxed out, every 10 MW of increased demand needs the full 10 MW of new plant

# United Energy benchmarks as efficient - yet our costs are rising




Source: EUAA

# The AER's proposed Rule changes

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*Our summary*

First Tier

1. Setting Opex and Capex allowances – process and discretion
2. Capex incentive mechanism (including contingent projects)
3. WACC – Statement on Cost of Capital (SoCC) including changes to Cost of Debt

Second Tier

4. Shared assets
5. Related Party Margins and Capitalised Overheads
6. Changes to regulatory processes

# But first -
# The key questions to be answered:

- How much of the recent price rises are caused by issues with the Rules?
  - And how much is from underlying structural issues – aging assets, peak demand, etc?
  - How much derives from inexperience in application of the rules (rather than the rules themselves).

- Is there a problem with the Rules, that warrants a change?
  - Is there evidence to support the proposition?
  - The 2006 process to establish the current framework was focussed on giving confidence to investors to support efficient investment – noting significant investment was needed in the years that followed
  - Nothing has changed
    - investment is needed,
    - stability and confidence are important

# The rule change process

- The national electricity and gas legal frameworks separate the rule maker from the rule enforcer
  - The AEMC sets and changes the rules
  - The AER is the rule enforcer
    - The AER is entitled to propose rule changes to the AEMC – as it has recently done
  - This separation of rule making and enforcement is an important structural feature of the framework, aimed at ensuring stability and confidence

- The AEMC has recently set out a process:
  - It has published a high level consultation paper looking for initial responses - due in December
  - There are several steps in the process - over next 12 months.

# Information asymmetry

Thinking that causes us great concern:

Thinking where the AER:

1. Believes there is significant information asymmetry
   > i.e. where the AER is concerned that it does not have a detailed understanding of the DB or its costs
2. Believes that the price setting process gives the DB an incentive to inflate its forecasts
3. Therefore assumes that the DB does inflate its forecasts
   > without the AER testing the DB's forecasts
4. Uses its new discretion to remove the premium that they assume is built into the forecasts.

Rule changes based on the above will have major flaws:

- They will be built on distrust - rather than on the openness transparency
- They ignore the rigorous legal process set by the AER for "signing-off" forecasts
- They penalise the diligent, the honest and the efficient
- They will create a downward spiral – never ending.

# Solutions to the asymmetry dilemma

- Develop the capability to overcome the asymmetry
  - Embed resources in the AER with good utility knowledge and experienced (engineers, etc)
  - Ensure the AER can better use/understand the information they discover from the DBs – through good quality staff and other resources
  - Strengthen consumer advocacy
- Develop a framework that has less need for the regulator to have an equal understanding of the business as the DB
  - Note that the previous Victorian model was designed this way
  - Seek to align the interests of DBs and customers
  - Note that the current national electricity Rules (Chapters 6 and 6a) were designed to incentivise the NSP to forecast accurately
  - Adopt a competition by comparison framework
- Or a combination of the above

*But setting up a mechanism where the DB forecasts are discounted without reasonable basis (on the assumption of being inflated) cannot meet the National Electricity Objective*

# Therefore UE & Multinet's current thinking on the AER's proposed Rule changes

1. We are very concerned about a lack of confidence in the price setting process – and are thinking about how confidence can be re-established
   - Strengthen the AER – improve capability, quality and longevity
   - Strengthen consumer advocates – increase funding
   - Ensure that the Rules give incentives for efficiency
   - Ensure that the Rules give incentives for accurate (balanced) forecasting – and we support robust benchmarking to test efficiency

2. The Rules should be able to work as originally planned
   - We believe that the AER can do most of what it wants/needs under the existing Rules
   - We are keen to engage with the AER/AEMC on the intent of the Rules
   - We are open to improvements where the Rules are not working as planned

# UE & Multinet's current thinking on the AER's proposed Rule changes

3. WACC changes
   - We are open to look at a SORI approach across the board – it has attractions
   - But must look at how best to manage risk efficiently – how will the SORI handle the next GFC?
   - Concerned that the AER has picked the one WACC approach that cannot be subject to merits review
   - We note that the AER sees no need for consistency between gas and electricity for the Capex and Opex rules- their drive for consistency is limited to the WACC rules.

4. Ensure decision making is robust, predictable and accountable
   - Decision making must be evidence based
   - This applies to both the AER's decisions, and the AEMC's process to consider changes to the rules
   - Note that Rules that were designed (in part) to give investors confidence for 40 year investments, are less than 5 years old.

# Conclusion

- Prices are on the rise
- Consumers and policy makers are understandably concerned
- We must look if changes are needed to ensure the Rules work as intended
- We must all ensure confidence in the regulatory process
  - Customer confidence
  - Policy maker confidence
  - Investor confidence
- Overcome the concern of information asymmetry
- Ensure good incentives drive efficient outcomes
- Ensure a robust and accountable decision making processes – evidence based.