PowerWater

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Dr Patrick Walsh
Utilities Commissioner
Utilities Commission
GPO Box 915
DARWIN NT 0801

Dear Dr Walsh

Re: Revoke and Reset of Networks Revenue Determination

As the network provider regulated under the *Electricity Networks (Third Party Access) Code* ("the Code"), PWC requests that the Commission exercise its powers under **clause 71(c)** of the Code to initiate the process necessary to revoke and reset the networks revenue determination as soon as possible; certainly well before the scheduled commencement of the next regulatory control period and preferably as soon as 1 April 2013.

The Commission is urged to take this step on the grounds that the revenues currently being generated by regulated network tariffs – tariffs that are set in accordance with the Commission's 2009 determination ("the 2009 reset") – demonstrably fall substantially short of the revenue required to ensure the on-going commercial viability of the network provider contrary to **clause 68(j)** of the Code.

The NT Government has recently confirmed that it expects all its utilities businesses to be commercially sustainable, and that the past policy of sub-par rates of return on assets will no longer be tolerated. To that end the Government has initiated reviews aimed at identifying and remedying the inadequate commercial returns being earned by PWC across its various business lines, and has charged the PWC Board and management with the task of vigorously pursuing all available options for returning each business line to commercial sustainability. PWC considers that ensuring regulated network tariffs are fully reflective of current costs (which is the responsibility of the Commission) has just as much of a role to play in restoring PWC Networks to commercial sustainability as does the pursuit of efficiencies (which is the responsibility of our Board and management).

Against this background, our latest estimate is that, based on the network tariffs now in place, PWC's regulated network assets are achieving a pre-tax (real terms) rate of return on capital employed of around *negative* 3% in the 2012-13 financial year, using DORC asset values and current projections of operating and capital expenditure programs. This is patently short of being commercially sustainable, and severely undermines the commercial viability of our regulated networks business.

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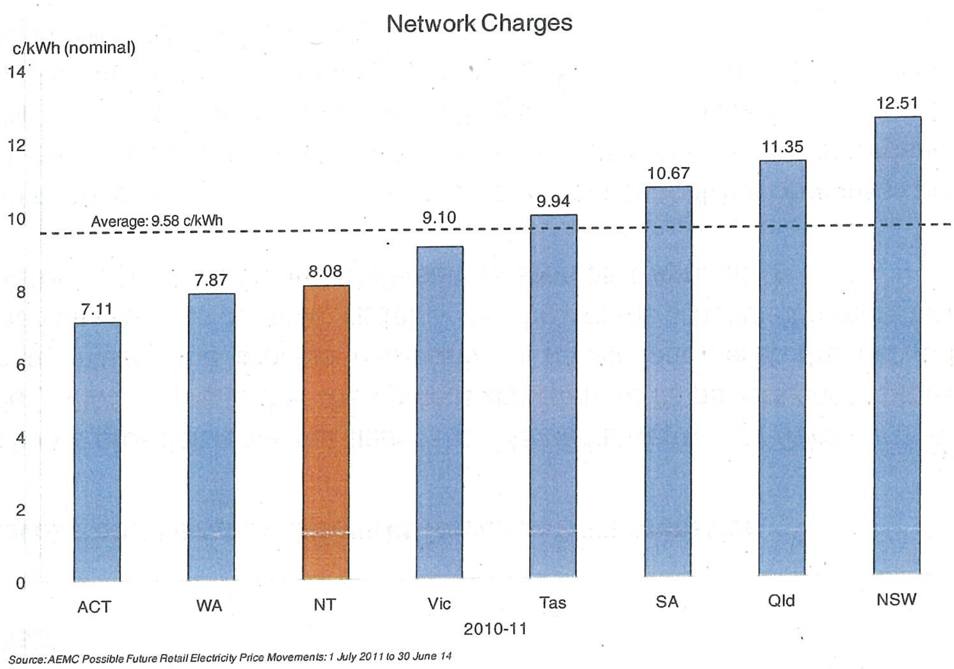
While the Commission may judge that some of this shortfall to be a reflection of 'inefficient' capital amounts and spending levels, PWC's view is that there has to be limits to the extent to which inefficiencies are used to justify actual rates of return on capital that are so clearly below the regulatory cost of capital before the commercial viability of the business is threatened. In fact, even if no more than one-half of the rate of return shortfall currently evident was to be attributed to such inefficiencies (something PWC would not find reasonable or capable of justification), this would nevertheless imply that average network tariffs are in the order of 50% below the level required to earn an appropriate rate of return on capital employed.

In support of our views regarding the current inadequacy of regulated network tariffs, we bring to the Commission's attention the fact that such tariffs in the Territory clearly lag those in most other States as is evident from average network price comparisons published by the AEMC.

Chart 1 depicts the gap applicable in 2010-11. In this year, the NT's network tariffs would have had to increase by also 20% to match the unweighted average of the other States and Territories.

Chart 1



Reflecting regulated tariff increase in some of the other States, it is PWC's understanding that the 2011-12 data (not yet published by the AEMC) suggests that the NT's network tariffs would have to increase by around 32% to match the unweighted average of the other States and Territories.

There are no grounds for believing that the characteristics of the NT electricity networks (small, linear) on balance justify 'efficient' network tariffs in the Territory which are below those evident elsewhere in Australia on average, in fact the opposite is the case.

Power and Water's main concern is not "if" network tariffs have to rise substantially, but "when". Delaying the reset for a further 18 months – until the inevitable "Z factor" adjustment (the term used in the 2009 reset) – will only further erode our regulated networks business's capacity to maintain adequate service standards or to finance appropriate rates of infrastructure renewal and expansion.

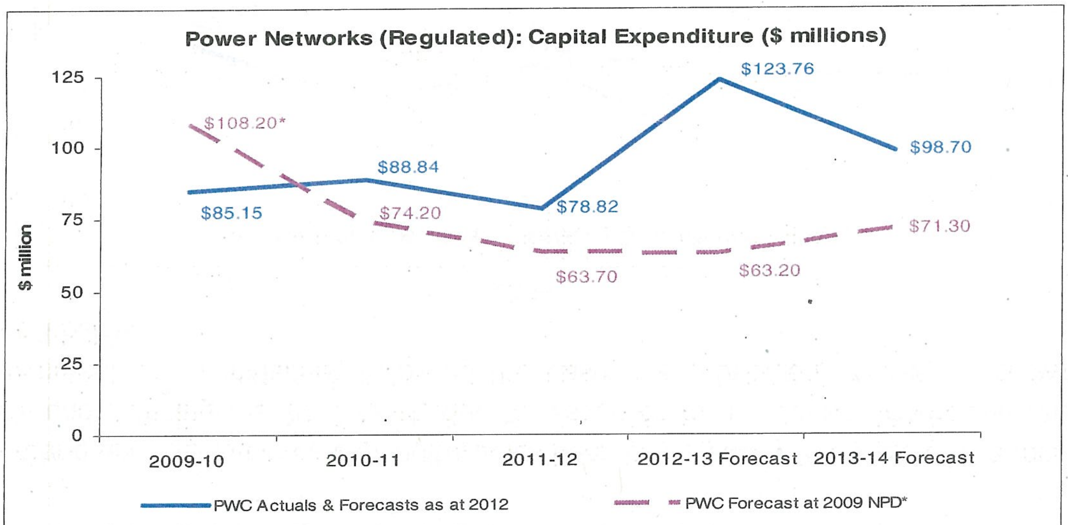
The main reasons why network tariffs based on the 2009 reset fail to ensure the on-going commercial viability of PWC's regulated network business are as follows:

(1) The opening regulated asset base (RAB) used in the 2009 reset was based on a value derived from future cash requirements analysis. Such a valuation does not provide sufficient funding for return on or return of capital of the actual assets which comprise PWC's electricity network. PWC believes, noting the history and development of regulated asset valuation methodologies adopted over time, that the appropriate valuation is depreciated optimised written down cost (DORC). SKM undertook a comprehensive review of PWC's electricity network assets in 2007, ascribing a DORC valuation at that time of $562 million.

As at 30 June 2011 the rolled forward value of the network RAB using the SKM DORC valuation was $734.5 million, versus the rolled forward UC determined value of $501.9 million, a difference of $233 million.

(2) Capital spending on network infrastructure, and the associated impact on the RAB, has been considerably in excess of the forecast levels underpinning the 2009 reset, due to responses to the Davies Report and related Government policy initiatives following the Casuarina substation failures, as shown in chart 2 below:

Chart 2

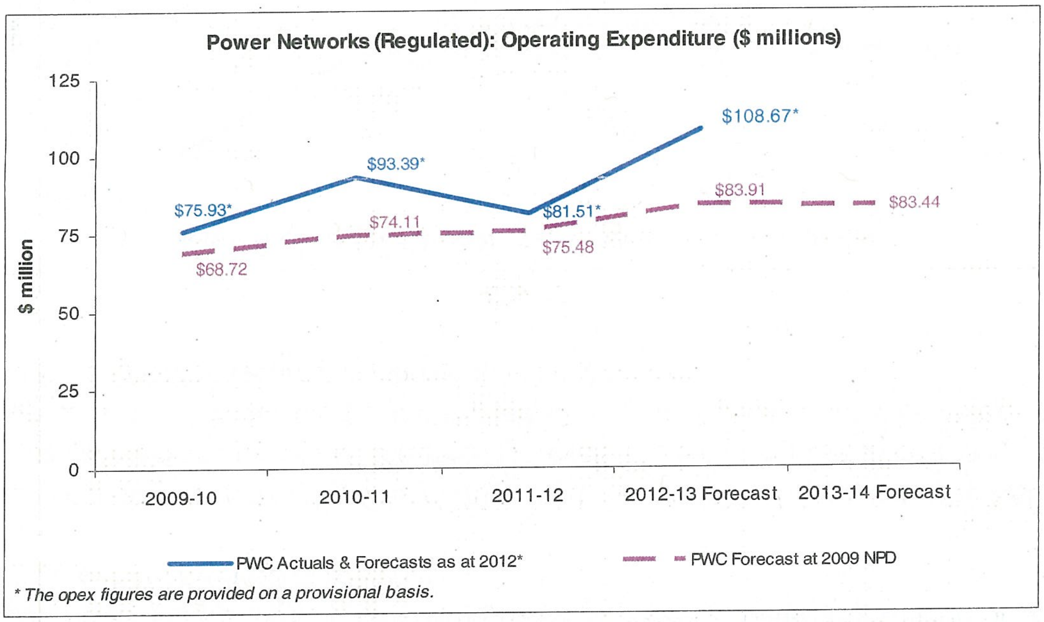


** The PWC forecast at the 2009 NPD was estimated in November 2008, after the Casuarina ZSS incident, hence the high capex estimate in 2009-10.*

The Commission's report at the time of the 2009 reset acknowledged that network tariffs would have to be revisited once the Government's decisions were known in response to the Davies Report. That revisit is well overdue.

(3) Operating and maintenance expenditure has been considerably in excess of the forecast levels underpinning the 2009 reset, due to responses to the Davies Report and related Government policy initiatives following the Casuarina substation failures, as shown in chart 3 below:

Chart 3



(Note – PWC is currently transitioning to a new asset management system. Issues have been encountered with the segregation of regulated Power Networks and System Control reporting, resulting from issues with the integration of the Financial Management System with the new asset management system. The outputs as depicted have not yet been fully tested).

Therefore, in accordance with clause 71 (and clause 68) of the Code, PWC urges the Commission to initiate the process necessary to revoke and reset the networks revenue determination as soon as possible – as a necessary step towards restoring the commercial viability of PWC's regulated networks business.

Yours sincerely

Andrew Macrides
Managing Director
14 December 2012

CC:
Vanessa Sutcliffe, Utilities Commission
Alan Tregilgas, Under Treasurer