

MAJOR ENERGY USERS INC

10 May 2006

Dr. John Tamblyn
P O Box H166
Australia Square
NSW 1215

Dear Dr. Tamblyn,

AEMC Rule Change Proposal: Asset Value and Depreciation

I attach a note prepared for the Major Energy Users in relation to the AEMC's proposed Rule change on asset value and depreciation.

We believe that the approach proposed by the Rule change will provide a windfall benefit to regulated businesses, at the expense of energy consumers.

Yours sincerely

Mark Gell
Chairman

C.c. Steve Edwell
Australian Energy Regulator

Level 9, 92 Pitt Street
Sydney NSW 2001

Regulatory asset values, depreciation and performance

The Roll forward anomaly

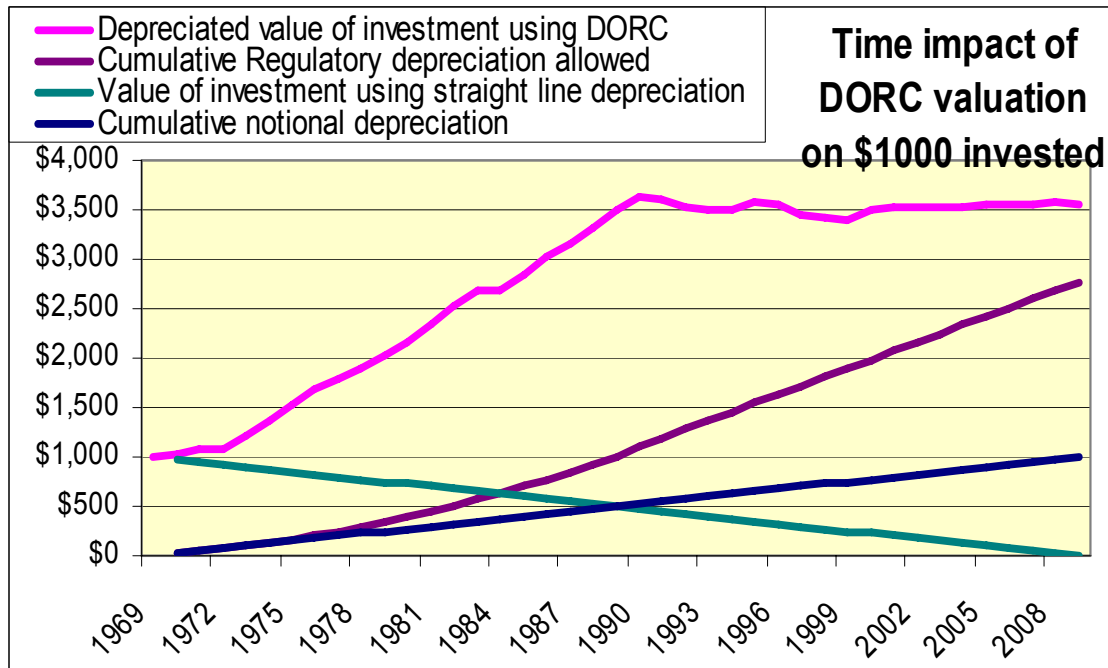
Over time the assets used in providing the service are determined to be no longer appropriate for use and the regulator permits the asset to be replaced. In its decision the regulator sets a period for the economic life of the different assets and at the end of this period the asset is deemed to be no longer “used and useful” and is to be replaced by a new asset performing the same service. To accomplish this, capex is granted in the regulatory decision for this to occur. At the same time the asset base is increased by the cost of the capex needed for the replacement and the old asset is assumed to be removed.

Current regulatory practice is that the regulated asset base is valued at its replacement cost, depreciated towards its economic life and this amount is automatically rolled forward. This is referred to as the depreciated optimized replacement cost (DORC) method of valuation but the regulatory approach is that the asset is seldom if ever optimized (following practice used by a number of jurisdictional regulators to reduce regulatory risk for the businesses) and so in reality the approach is more appropriately designated the depreciated replacement cost (DRC)¹ method of valuation.

This process is different to those used by most competitive businesses in that normally the actual cost of an investment is depreciated over time so that at the end of the economic life of the asset, the book value for the asset is zero. This is referred to as the depreciated actual cost (DAC) method for asset valuation

In the following graph it has been assumed that there has been an investment of \$1000 in 1969. This amount has been adjusted annually using the CPI over the past 40 years as published by the Reserve Bank of Australia with the final years (that for the next regulatory period have been extrapolated assuming a CPI for these years of 2.75%, just as a regulator would do. The asset is assumed to have an economic life of 40 years, (this is the average of all assets in a portfolio) although some regulated assets are allocated longer lives than this. All depreciation is assumed to be linear, just as in regulatory decisions.

¹ The current review of the electricity Rules by AEMC actually codifies this approach by excluding the ex post optimizing of an asset due to regulatory risk concerns.



It would be expected that after 40 years, the asset has to be replaced as it is no longer useful and therefore has no value. (ie the green line would apply). The pink line is the depreciated DORC value and shows that after the asset has to be replaced there is a residual value for the asset due for replacement of \$3,566. (ie, even after the asset is replaced there remains a value in asset register of \$3,566 for an asset which has been removed and replaced). At the time of the replacement the new asset is installed using capex of \$9,816 (the initial value of \$1000 escalated for the 40 years).

This shows two extreme anomalies.

- The new asset is replaced and has to be effectively included in the asset register at \$9816 (its cost of replacement) + \$3566 (the residual on the asset register for the removed asset). This means that the new asset has to be included in the asset register at \$13,382 ie a premium of 35%.
- Consumers have paid a total of \$2774 over 40 years to depreciate an asset initially valued at \$1000. ie a premium of 277% and yet the asset remains on the register at a larger value than the amount it was first purchased at even though it is no longer in existence.

This issue goes further.

Assuming the annual real WACC payable under the regulatory decision is the 10 year bond rate plus 3.5%² less CPI, and using actual bond rates for the last 36 years and extrapolated the last four years at 5.30% (again as would a regulator do), it means that over the 40 year period consumers would have paid:-

- \$8,264 for the use of the \$1000 asset over the 40 years.
- Total payments of \$11,038 over 40 years including return on investment and regulatory depreciation for the \$1000 investment made.

This total payment is equivalent to the amount paid on a loan of \$1000 over 40 years at a fixed 27.5% interest rate.

Even if the current bond rate (5.28%) and CPI (2.75%) were constant at present values for the entire 40 years, the implied real interest rate is still some 40% greater than the regulatory real interest rate of 6%, and the residual value of the “fully depreciated” and “useless” asset would be \$1036, increasing the asset register value for the replacement asset by 43% above the replacement value.

What is now apparent is that the depreciation a regulated business is able to provide for in its chart of accounts is not real as the regulatory approach allows the regulated business to effectively retain the value of the depreciation within its regulated asset base, and depending on the inflationary trends to accrue even greater amounts of depreciation within the RAB.

As depreciation is a “non-cash” item in the profit and loss statement, the regulated business is therefore able to utilize its accounting depreciation allowance as a means of providing for its dividend payout without suffering any future consequences.

Conclusions

Consumers have been concerned that the Utilities sector (comprising almost entirely of regulated businesses have been seen to excessively outperform the market benchmark of the ASX 200³.

There is no doubt that the approach used to carryout the regulatory valuation and depreciation of the regulated assets provides a windfall benefit to regulated businesses and provides the evidence as to why the Utilities sector has so clearly out performed the market average. It also explains why regulated businesses are able successfully trade with a balance sheet and P&L which might otherwise suggest that trading was close to financial limits.

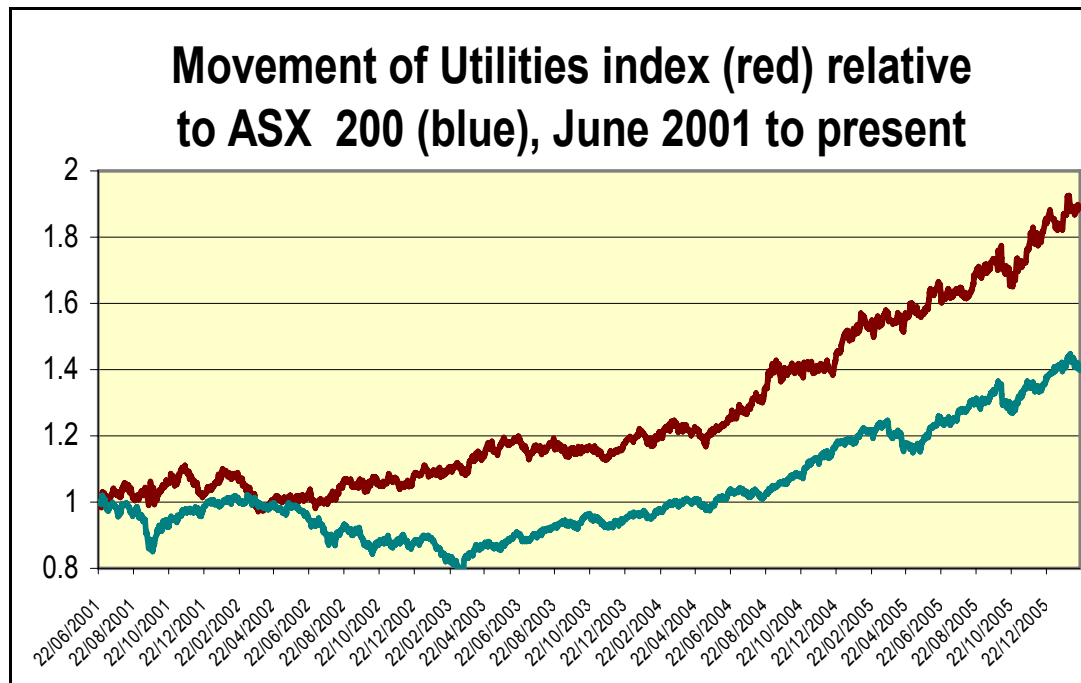
² This is the average of the mark up mark up used by ESCoSA in the Envestra DD

³ See appendix 1.

Appendix 1

The Performance of the Utilities sector

The following graph shows the Utilities sector share performance over the past five years compared to the share average as defined by the ASX 200.



Source: Commonwealth Securities

The ASX 200 has been recognized to be particularly buoyant in the past 2-3 years as a direct result of the “China resources” boom. This should not have impacted on the Utilities index yet despite the China resources boom impacting the ASX 200 companies but not the Utilities sector, the Utilities index has significantly outperformed the market average overall, but particularly even during the China boom period. This shows that the companies within the Utilities index are seen as extremely profitable businesses, compared to risk.

A review of the companies comprising the index shows that DUET, Hastings, Alinta, AGL, APT, Envestra, GasNet, SPI AusNet, Spark Infrastructure are all in the index and between them, they comprise over 90% of the index capitalization – supporting the following assessment.

Analyzing the figures provided by Commonwealth Securities (CommSec) shows that the ASX 200 demonstrates that market risk premium (MRP) for the sector for the past five years is 6.05%, about the long term average, rising from an MRP of between 3-4% observed for the past 30 years. This would be expected as the ASX 200 has been recognized to have been heavily influenced by the China

resources boom. CommSec has calculated an equity beta for this sector⁴ at 1.08, again about the average for the long term market average.

In comparison, analyzing the figures provided by CommSec shows that the Utilities index demonstrates an MRP of 11% for the sector for the past five years. This is despite the fact that regulators have been setting an MRP of 6% in all regulatory decisions made during the same period, as well as for the five years before. CommSec has calculated an equity beta for this sector at 0.31, less than one third of the value used in all regulatory decisions up to late 2004.

⁴ See appendix 2 which provides a listing of equity betas and sector and subsector dividend yields for each market sector. This data was sourced from Commonwealth Securities.

Appendix 2

Data sourced from Commonwealth Securities Web site

Sector	Sub-sector	ASX code of typical company	Beta 27Feb06	Sector dividend yield 27Feb06
All ordinaries			1.08	4.3
Consumer discretionary	Automobiles and components	OEC	1.02	6.2
	consumer durables and apparel	GUD	1.75	5.3
	consumer services	TAH	0.93	4.3
	Media	PBL	1.51	4.5
	Retailing	HVN	1.18	4.6
Consumer staples	Food and drug retailing	WOW	0.62	3.8
	Food beverage and tobacco	LNN	0.58	4.3
Energy	Energy Equipment and services	HZN	0.96	3
	Oil and Gas	ORG		
Financials ex property	Banks	CBA	0.86	4.3
	Diversified financials - resources	BNB	1.19	3.5
	Diversified financials - holdings	SOL	1.19	3.5
	Insurance	AMP	1.58	4.2
Property Trusts	Investment trusts management and development	WDC	1	6.9
		CEQ	1	6.9

Sector	Sub-sector	ASX code of typical company	Beta 27Feb06	Sector dividend yield 27Feb06
Health Care	Equipment and services	SHL	1.19	2.8
	Pharma & Biotech	SIP	1.81	2.3
Industrials	Capital goods	COA	1.11	4
	Commercial services and supplies	BIL	1.11	4
	Transportation	ADZ	0.9	4.7
Info Tech	Software and services	CPU	1.82	4.6
	hardware and equipment	KYC	1.15	4.4
	Semiconductors	LGD	1.15	0
Materials			1.39	3.1
	Chemicals	ORI		
	Construction materials	ABC		
	Containers and packaging	AMC		
	Aluminium	AWC		
	Diversified metals and mining	BHP		
	Gold	NCM		
	Precious metals and minerals	ERA		
	Steel	BSL		
	paper and forest products	PPX		
Telecommunications			0.44	5.7
	Diversified	ENG		
	Wireless	HTA		
Utilities			0.31	5.2
	Electric	HDF		
	gas	ALN		
	Multi	SPN		
Unclassified		BQF	1	6.9