OFFICE OF THE CHIEF EXECUTIVE

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2 April 2015

Paula W Conboy
Chair
Australian Energy Regulator
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Dear Ms Conboy

Draft Powerlink Framework and Approach – Preliminary Positions

Powerlink welcomes the opportunity to respond to the Australian Energy Regulator's ("AER") paper *Draft Powerlink Framework and Approach – Preliminary Positions* ("the draft paper").

Powerlink has comments to offer on three elements of the draft paper:

- the proposed application to Powerlink of a new version of the Service Target Performance Incentive Scheme ("STPIS");
- the proposed ex-post review of Powerlink's capital expenditure in the current (2012/13 – 2016/17) regulatory period; and
- the discussion of Powerlink's proposal to apply a top down approach to forecasting capital expenditure for its next Regulatory Control Period.

1. Review of the STPIS

Powerlink now operates under version 3 of the STPIS. The current version of the STPIS is version 4.1 which the draft paper states the AER intends to apply to Powerlink for its 2018-22 regulatory period. Powerlink agrees that this is a reasonable step by the AER.

The draft paper also states that the AER plans a review of the STPIS in 2015. It further states that, if the STPIS is amended in light of that review, the amended STPIS will be applied to Powerlink over 2018-22. Powerlink does not have an in-principle issue with such an approach; however it has identified practical matters associated with the timing of the review and the quantity and complexity of any changes to the STPIS which will need to be considered.

It is important that the AER, if it intends to apply outcomes of a 2015 STPIS review to Powerlink's 2018-22 Regulatory Period, gives Powerlink sufficient time to incorporate relevant changes in its Revenue Proposal or Revised Revenue Proposal. Powerlink would be required, for example, to analyse associated historical data to enable development of new targets, collars and caps which may take several months depending on the outcomes of the review.

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In its discussion of the Network Capability Component (NCC) of the STPIS, the draft paper states that transmission businesses were not incentivised to implement low cost projects which either improve network capability at times when customers most value it, or improve wholesale market outcomes at least cost. Powerlink disagrees with this claim and has a history of implementing such projects without application of the new NCC incentive. Powerlink advised the AER in the context of early application of Version 4 of the STPIS that given its current regulatory arrangements (and allowances), it was not necessary to be further incentivised to investigate and deliver projects of the nature contemplated by the NCC.

2. Ex-Post Review of Capital Expenditure

The draft paper states that the AER's preliminary position is to undertake, in the next Regulatory Period, a review of Powerlink's capital expenditure in the current period. The paper also states that "in this unique circumstance" the review would be confined to a single year, presumably the final year of the current period.

Powerlink requests that the AER provide additional information about how it proposes to conduct such a review. The AER's *Capital Expenditure Incentive Guideline for Electricity Network Service Providers* ("the Guideline") sets out a two stage process. Stage One considers whether a Network Service Provider ("NSP") has overspent its allowance, whether the overspending was significant and the history of the NSP's capital expenditure. Stage Two comprises a detailed assessment of the drivers of the NSP's capital expenditure and its management and planning tools and practices. The Guideline then states that the AER will consider the reasonableness of the NSP's justification for its overspending, any other mitigating reasons and whether the NSP's processes and procedures were so as to ensure that its spending was efficient and prudent. It is not clear to Powerlink, from the discussion in the Guideline, how the AER would determine particular elements of an NSP's expenditure which it may consider to not be efficient or prudent. For example, if total capital expenditure varied from the forecast across a large number of projects, Powerlink is interested in understanding how the AER would conduct its assessment.

3. Capital Expenditure Forecasting Methodology

The draft paper discusses Powerlink's proposal to apply a top down approach to forecasting capital expenditure for 2018-22. This approach would reduce the resources and costs required to prepare the Revenue Proposal and similarly reduce the resources the AER and stakeholders need to deploy to consider the Proposal.

Powerlink appreciates the AER's agreement to publish on its website Powerlink's letters of 31 October 2014 and 6 February 2015 which discuss its proposed approach to forecasting capital expenditure. Nonetheless, it is worth reiterating a number of important points in this response to the draft paper.

For clarification, Powerlink currently intends to apply a top-down capex forecasting approach to only:

- Replacement expenditure using the AER's repex model and other information;
- Security/compliance and other using a form of top-down trending; and
- Business IT using a form of top-down trending

Powerlink currently intends to support its top-down forecast approach with bottom-up testing from actual expenditure which is possible in the early years of the revenue proposal. All other capex category forecasts are intended to be bottom-up.

First, Powerlink's top-down forecast approach would not be applied to all categories of capital expenditure. Second, the draft paper states that Powerlink would:

> "use a bottom-up build for projects that are known and/or underway in the early years of the next regulatory control period and a top down approach for projects later in the period, with a proportion of the latter projects also supported by a bottom-up build".

Powerlink emphasises that its top-down capital expenditure forecast would cover the whole of the 2018-22 regulatory period and justification will be provided in support of that forecast. These points are further discussed below.

Load driven capital expenditure is driven by needs for network augmentations and connections. Given current low demand growth forecasts, and the consequentially few expected investment triggers for projects, Powerlink considers that its Revenue Proposal for the 2018-22 regulatory period is likely to include minimal load driven capital expenditure. Powerlink considers that the complexity of developing a top-down forecasting technique for load driven capital expenditure would not be warranted under these conditions. As set out in Powerlink's letter of 6 February 2015, such load driven capital expenditure will continue to be forecast using a bottom up methodology.

Powerlink's proposal to apply a top-down forecasting methodology applies to other categories of capital expenditure, particularly asset replacement as well as other network and non-network expenditure. Powerlink expects that the techniques to be employed would include one or more techniques used now by the AER, such as replacement expenditure modelling and base-step-trend analysis. Powerlink is examining how to incorporate more of its asset management practices and decision making framework into the existing models, particularly the AER's replacement expenditure model.

Top down forecasts, as noted in Powerlink's letter of 6 February 2015, by definition do not identify individual investment triggers, options analysis and detailed project scopes and estimates. Powerlink envisages that the supporting information it will provide would be different to that provided in its previous Revenue Proposals.

Previously, practically all forecast capital expenditure was supported by such documentation, although it varied by stages of solution or individual project development. Powerlink's Revenue Proposal for the next regulatory period is proposed to include forecast capital expenditure across three distinct phases of expenditure commitment:

- projects that are already approved and committed;
- projects for which specific investment triggers have been identified and which are progressing towards approval; and
- investment triggers that are still some way into the future and for which firm solutions are yet to be developed.

The timing of a need and the stage of development of a solution or project affects the level of detail which is available to include in supporting information. For example, Powerlink considers that it is reasonable to expect more detailed supporting information for projects already approved and committed than for investment triggers that are some way into the

future. As part of a Revenue Proposal, forecasts are required for up to eight years in the future; projects earlier in the forecast period are based on much firmer information than forecasts of investment triggers seven or eight years hence.

Powerlink trusts that this information will assist the AER's development of the Framework and Approach. If the AER has further questions about the matters raised in this letter please contact Powerlink's Revenue Reset Leader, Don Woodrow.

Yours sincerely

Merryn York.

Merryn York
CHIEF EXECUTIVE

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