

AER Consumer Challenge Panel

CCP4 Sub-Panel Submission

Draft Powerlink Framework and Approach (F&A)

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David Headberry and Jo De Silva

AER Consumer Challenge Panel (CCP4) Submission on the Draft Powerlink Framework and Approach

1. Purpose

This submission is provided in response to the AER's preliminary positions outlined in the AER's *Draft Powerlink Framework and Approach Preliminary Positions* document, dated March 2015.

2. Service Standard Performance Incentive Scheme (STPIS)

CCP4 notes that the AER proposes to apply Version 4.1 of the STPIS to Powerlink for the 2017-22 regulatory control period.

We acknowledge that a well-designed STPIS scheme should be able to provide safeguards to consumers whilst incentivising appropriate levels of reliability performance.

However, the CCP4 is concerned that the apparent asymmetric outcomes of the STPIS scheme to date implies that the current design and implementation of the STPIS scheme might not deliver outcomes that are in consumers' long-term interests.

CCP4 has a number of concerns regarding the design and implementation of the STPIS scheme and does not consider that the recent changes to Version 4.1 of the scheme are likely to address those concerns. We consider that applying Version 4.1 of the scheme would continue to provide major unwarranted bonuses to Powerlink over the next regulatory control period.

CCP4 notes that the AER has committed to undertaking a review of the transmission STPIS during 2015 and that the review will be completed prior to the commencement of Powerlink's next regulatory control period. We also note that the review is expected to result in further revisions to the transmission STPIS and that the AER has committed to applying those revisions to Powerlink during the 2017-22 period.

Therefore, rather than outlining our concerns within this F&A response, CCP4 will provide a detailed submission to the AER's formal review of the transmission STPIS scheme.

3. Operating expenditure forecasting and Efficiency Benefits Sharing Scheme (EBSS)

CCP4 supports incentive schemes that deliver genuine efficiency improvements and long-term benefits to consumers. However, CCP4 is concerned that the outcomes of the Powerlink EBSS to date imply that opex allowances previously provided were above the efficient level.

The AER's benchmarking results¹ indicate that the AER's decision to not apply benchmarking when making its previous revenue determinations imply excessive opex allowances were granted of up to 60% above the efficient level. This has very serious implications for the ongoing application of the EBSS scheme.

CCP4 notes that, contrary to the intentions outlined in its Framework and Approaches for the NSW and ACT distribution networks, the AER subsequently decided not to apply the EBSS in its draft decisions.

¹ Electricity transmission network service providers - Annual benchmarking report, November 2014

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The AER's rationale for that decision was predominantly based on the fact that the AER determined (through benchmarking) that the DNSPs' base opex levels are materially inefficient, and therefore the AER placed less weight on the revealed costs in its determination of their efficient base year costs.

In essence, the AER concluded that by implementing an opex allowance based on the outcomes of benchmarking the DNSPs will face strong incentives to make efficiency improvements while their actual opex is higher than an allowance based on benchmarking, and therefore there is no need to apply an EBSS to further strengthen those incentives.

The Rules formally require the AER to undertake benchmarking to assess the relative efficiencies of the transmission networks, and to apply the outcomes to determine efficient costs.

The AER's transmission benchmarking results² demonstrate that Powerlink is consistently in the lowest productivity cost range for transmission networks and well removed from the efficiency frontier. Consequently, CCP4 considers that the outcomes of benchmarking will be essential in the determination of the efficient base-year opex for Powerlink.

In light of the AER's decision not to apply the EBSS to the NSW/ACT distribution networks, we consider that the AER should outline within the Final Powerlink Framework and Approach, the conditions under which the EBSS might not be applied to Powerlink.

4. Capital Expenditure Forecasting

4.1 The AER's Expenditure Forecast Assessment Guideline

The AER's Draft Powerlink Framework and Approach outlines the AER's intention to apply its *Expenditure Forecast Assessment Guideline for Electricity Transmission (the guideline)*³ to Powerlink for the 2017–22 regulatory control period.

The guideline was developed through extensive consultation with a diverse range of stakeholders over a 12-month consultation period.

It outlines the types of assessments the AER will perform to determine efficient expenditure allowances, and the information required from the network businesses to enable the AER to do so. It is based on a nationally consistent reporting framework allowing the AER to compare the relative efficiencies of TNSPs and to decide on efficient expenditure allowances.

The guideline outlines a suite of assessment/analytical tools and techniques, including:

- Benchmarking (economic techniques and category analysis)
- Methodology reviews
- Governance and policy reviews
- Predictive modelling
- Trend analyses

² Electricity Transmission Network Service Providers Annual Benchmarking Report, November 2015

³ AER Expenditure Forecast Assessment Guideline for Electricity Transmission, November 2013

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- Cost benefit analyses
- Detailed project reviews (including engineering review)

The guideline enables the AER to exercise its judgement in determining the extent to which it applies the above techniques. This provides the AER with a high degree of flexibility and recognises that a range of different estimating techniques are likely to be required to effectively assess the TNSPs' expenditure forecasts.

4.2 Powerlink's Proposed Capex Forecasting Methodology

Powerlink has indicated its intention to predominantly apply a 'top-down' approach to its capital expenditure forecasting for the next period. Powerlink claims that *“This approach will significantly reduce the cost to Powerlink of preparing its Revenue Proposal, and might similarly assist the AER and stakeholders in terms of the time, effort and cost to review and assess Powerlink's Proposal”*⁴

4.3 CCP4's Perspectives on Powerlink's Proposed Capex Forecasting Methodology

CCP4 has a number of concerns with Powerlink's proposed capex forecasting approach.

In particular:

- It would inappropriately and unnecessarily restrict the AER's ability to exercise its judgement in determining the extent to which it applies the techniques outlined in its forecasting assessment guideline
- It would not provide the AER with sufficient information to enable an accurate assessment of the prudent and efficient capital expenditure required by Powerlink
- In particular, the CCP\$ is concerned that using a top down assessment will not provide sufficient information as to the governance behind the development of the capex allowance, the risk assessments made underpinning the capex forecasts, the structure of the cost inputs and the rationale for the need for the capex claimed (eg such as would be included in a RIT-T).
- Use of a top down assessment in isolation for repex would not factor in a detailed assessment of the risk assumptions used for replacement of assets, nor of the risk inherent in deferring such replacements.
- The application of a range of assessment techniques (including top down and bottom up techniques) is essential for properly assessing the prudence and efficiency of the networks' proposed capital expenditure
- Various elements of Powerlink's capex are largely non-recurrent and require the application of bottom up assessment techniques
- It would result in an over-reliance on the use of Powerlink's historical capex costs and trends, which have not been demonstrated to be efficient
- Powerlink's claims regarding the reduced costs associated with its proposed forecasting methodology are questionable
- We consider that the boards of prudent asset intensive entities would not allow their capital investment decisions to be developed on the basis of 'top down' assessments, and would ensure

⁴ Letter from Powerlink to the AER dated 6th February 2015

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that effective governance arrangements are in place that also require bottom-up assessments to be applied

- Powerlink’s lack of justification for such a radical departure from the AER’s forecasting assessment guideline is very concerning
- It would be inappropriate for such departures to be “locked in” to the Framework and Approach
- Furthermore, Powerlink’s proposed departures would violate and/or restrict the application of the principles enshrined within the AER’s expenditure forecast assessment guideline – i.e. validity, accuracy & reliability, robustness, transparency, parsimony and fitness for purpose

In light of the above, CCP4 considers that:

- The AER should not endorse Powerlink’s proposed capex forecasting methodology as how Powerlink assesses its capex needs must be an issue for Powerlink to establish
- It is inappropriate for the AER to apply any constraints or limitations within the Powerlink F&A regarding the application of the *AER Expenditure Forecast Assessment Guideline*
- The most appropriate mechanism for Powerlink to demonstrate the merits of its capex forecasting approach is within its revenue proposal rather than in the F&A

5. Capital Expenditure Sharing Scheme (CESS)

The Rules formally require the AER to undertake benchmarking to assess the relative efficiencies of transmission networks, and to apply the outcomes to determine efficient costs.

The AER’s transmission benchmarking results⁵ demonstrate that Powerlink is consistently in the lowest productivity cost range for transmission networks and well removed from the efficiency frontier. Consequently, CCP4 considers that the use of benchmarking will be essential in the determination of efficient capex costs for Powerlink.

⁵ Electricity Transmission Network Service Providers Annual Benchmarking Report, November 2015