8 February 2007

energex

Office of the
Chief Executive Officer

Mr Mike Buckley
General Manager
Network Regulation North
Australian Energy Regulator
PO Box 1199
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Dear Mr Buckley

Australian Energy Regulator Draft Decision on Powerlink Queensland Transmission Network Revenue Cap from 2007/08 to 2011/12

ENERGEX is pleased to provide a submission on the Australian Energy Regulator's (AER) Draft Decision on Powerlink Queensland (Powerlink) Transmission Network Revenue Cap (the Draft Decision) from 2007/08 to 2011/12.

Powerlink is the monopoly provider of transmission network services to Queensland, and ENERGEX's electricity distribution network supplies the south-east corner of the State. Accordingly, ENERGEX has a substantial interest in ensuring that Powerlink has:

- reasonable and sufficient levels of capital expenditure (capex) to 2011/12 to replace ageing assets, build capacity to ensure reliable continuity of supply and meet peak system demand, and, more importantly, to continue to meet the state's growing energy demands;
- access to a reasonable return on assets; and
- sufficient incentives to efficiently use existing assets, and make prudent network investments in the long term interest of electricity customers.

Also, ENERGEX considers AER's regulatory decision on Powerlink's network revenue proposal will set precedents that will impact upon the future regulation of ENERGEX's distribution business.

ENERGEX's submission is not intended to address all matters covered by the AER's Draft Decision as there will always be distinctions between transmission and distribution businesses. Accordingly, ENERGEX's submission focuses on critical matters that it considers important from:

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- an operational perspective in terms of the risks resulting from the AER's draft decision; and
- a consistency of regulatory process issue – matters of precedent.

Operational perspective

As the monopoly transmission network operator, Powerlink has the responsibility of ensuring that the transmission network is able to deliver safe, secure and reliable energy to its two major customers, ENERGEX and Ergon Energy, at a reasonable price. For Powerlink, the substantial challenge to 2011/12 is successfully meeting the diverse needs of ENERGEX and Ergon Energy. From ENERGEX's perspective:

- Queensland continues to experience strong rates of growth in electricity demand as a function of an increasing customer base (baseline growth driven by population growth and changes to household density), changes to energy consumption patterns (with the most significant trend being the increased rate of air-conditioning penetration), and the increased activity in the small to medium size business sector, predominantly providing human services to the community;
- network investment processes and actual patterns of investment will substantially increase to not only meet these challenges, but to do so in accordance with recent service standards imposed as part of the distributors' licence conditions as per the Electricity Distribution Service Delivery[1] (EDSD) recommendations; and
- all electricity network providers currently must manage and respond to the impact of rising input costs.

This operational environment not only poses substantial challenges for Powerlink and the distributors, but it also requires the AER to set a regulatory contract with Powerlink that provides the business with reasonable certainty – both in terms of approved cost allowances and the allowed rate of inflation growth for these cost allowances.

Each of these matters is addressed in turn below along with comments on other significant matters.

Reasonable cost allowances

The critical elements of Powerlink's proposed regulatory arrangements to 2011/12, and the AER's draft decision are outlined in Table 1.

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[1] Independent Panel (July 2004), *Electricity Distribution and Service Delivery for the 21st Century*, Summary Report.

Table 1 – Powerlink Queensland's Transmission Network Proposal & AER Draft Decision

Element	Powerlink Position	AER's draft decision
Total revenue to 2011/12	$3.24 billion	$3.16 billion
Implied price impacts	10% increase (change from as commissioned to as incurred) 5.5% per annum (on raw or building block basis)	2% in 2007/08 5% per annum (smoothed basis)
Ex-ante capex	$2.44 billion	$2.03 billion
Contingent capex projects	$564 million	$890 million
Opex	$787.2 million	$712.6 million
Start asset base	$3.78 billion	$3.78 billion
Return on assets	8.34%	8.76%

ENERGEX does not support the AER's draft decision to reduce Powerlink's ex-ante capex allowance by $410 million, while increasing the contingent project allowance by $326 million. ENERGEX considers that this decision reduces investment certainty for Powerlink and will have flow on impacts for ENERGEX and our customers.

ENERGEX has particular concerns with this decision in terms of:

- the reduction to the load driven ex-ante capex allowance by $127 million based on accepting PB's finding (the AER's consultant) that the need for the investment could be deferred or delayed by managing the load at risk by Powerlink: (a) negotiating with a single customer to accept lower quality and security; and/or (b) implementing a demand side management (DSM) response (PB did not identify associated DSM projects);

- the reduction to the replacement driven ex-ante capex allowance by $110 million by adopting PB's top-down analysis of asset replacement need rather than Powerlink's bottom-up assessment of capex replacement projects; and

- the increase to Powerlink's contingent project allowance by $326 million, which incorporates a $233 million allowance for undergrounding.

ENERGEX's concerns on each of these matters are discussed briefly below.

ENERGEX considers that in cases where the AER, or its consultants, determine that the need for a capex project can be deferred or delayed (generally beyond the 2011/12 regulatory period) there should be at a minimum an onus on the AER to identify:

- the single customer that it considers best able to accept a lower standard of quality or security (on commercial in confidential basis); and

- the DSM project best able to meet the system safety, security or quality standard being addressed.

In the case of supply to Larapinta, ENERGEX notes that the AER have recommended that network augmentation be deferred on the basis that Powerlink is able to negotiate with one of its customers for a temporary lesser standard of supply. ENERGEX has concerns with the proposed arrangement as our previous experience is that large customers (i.e. customers that could logistically offer DSM) expect full N-1 reliability of supply and have been unwilling to enter into DSM agreements. In addition, ENERGEX understands that Powerlink has conducted public consultations regarding the proposed network augmentations and that no genuine DSM proponent has emerged. On this basis ENERGEX does not believe that the deferment of the project by the AER is prudent.

ENERGEX is also concerned with PB's assessment of the projects to establish Woolooga to North Coast 275kV DCCT Line and 275/132kV substation. ENERGEX undertook a joint planning study with Powerlink to address thermal and voltage limitations on the recently upgraded ENERGEX 132 kV network south of Woolooga which provides supply to loads at Gympie, Cooroy, Sunrise Hill and Noosaville. Although the immediate limitation relates to the section of line to Gympie, the sections south to Cooroy together with voltage limitations at Noosaville and Sunrise Hills are emerging issues which require subsequent reinforcement by 2016. The PB option did not take this into consideration.

Powerlink's recommended solution addresses these limitations and caters for both ENERGEX and Powerlink's longer term strategic plans, in particular ENERGEX's plans to establish a 132kV link east from Cooroy South to support the load of the North Coast area between Noosaville and Maroochydore. On this basis ENERGEX does not believe that the establishment of 275/132kV injection at Gympie as proposed by PB is prudent.

In assessing Powerlink's planning and investment practices in relation to replacement capex projects, PB found that Powerlink's procedures for identifying and prioritising its replacement requirements are consistent with "good industry practice". But despite this conclusion PB went on to find that:

- Powerlink's project scope on which the forecast [replacement capex forecast] was often greater than justified by the condition assessment;
- there was little evidence that Powerlink considered other options; and
- for these reasons Powerlink's replacement capex forecast should be considered an upper bound estimate.

Powerlink has used a condition-based bottom-up approach to assess its replacement capex. As a condition-based bottom-up assessment of replacement capex is more information intensive, ENERGEX believes that this approach can be considered more rigorous than the top down estimates used by PB.

ENERGEX utilises a similar approach to determining capex replacement need, and considers that the AER's draft decision on this matter potentially sets a precedent that might skew future regulatory processes to the detriment of electricity network businesses and their customers.

ENERGEX is concerned by the AER's draft decision of moving ex-ante capex allowance to the contingent project allowance. The purpose of the ex-ante capex allowance is to discipline Powerlink, and other regulated networks, to provide as accurate as possible capex forecasts to ensure alignment between asset base growth and the revenue (hence cash flow) stream implied by the change in the asset base.

ENERGEX's concern is that the AER's draft decision to effectively switch between certain and contingent capex reduces this incentive.

ENERGEX also considers that the increase in the contingent capex will result in increased costs to Powerlink within the regulatory period as it looks to monitor and, where necessary, comply with the relevant regulatory triggers set by the AER to allow for the contingent capex to be recognised and funded within the regulatory period.

Escalating costs

Powerlink proposed to escalate its capex and opex allowances for cost inflation by the following methods:

- labour escalator of 7.7% in 2006/07, 5.83% in 2007/08, and 5.6% per annum thereafter;
- non-urban property compensation escalator of 5% per annum;
- urban property compensation escalator of 8.6% per annum; and
- other escalator (except labour and property compensation escalators) of 2.7% in 2006/07, and 2.9% per annum thereafter.

The AER's draft decision accepted the 2006/07 and 2007/08 labour escalator, but set different escalation figures for 2008/09 (5.3%), 2009/10 and 2010/11 (3.5%), and 2011/12 (4%). ENERGEX notes that the AER's proposed labour escalation factor from 2009/10 to 2011/11 is below the historic rate of growth for wages in the utilities and construction sectors (last 5 years average annual growth 4.5% and most recent 3 years 5.5% per annum).

The accumulated difference between Powerlink's proposed labour cost escalator and AER's draft decision is 8%, which reduced Powerlink's ex-ante capex allowance by $22 million. The AER's draft decision also took a further $39 million from the ex-ante capex allowance as a result of using different cost escalators proposed by Powerlink for non-labour cost escalators.

ENERGEX considers that the setting of the correct cost escalation factor ensures the maintenance of the purchasing power of approved cost allowances over the regulatory period. This is critical to all stakeholders. ENERGEX recommends that the AER re-examine Powerlink's labour cost escalation factors, particularly from 2009/10.

To date almost all jurisdictional regulators have elected to use cost escalators which are based on economy wide measures of inflation (ENERGEX's current determination has cost inflation of 2.76%). Recent analysis undertaken by ENERGEX of material cost inflation shows price increases almost three to four times the official inflation data from the Australian Bureau of Statistics (ABS).

The separation between measures of economy-wide inflation and industry specific inflation for non-labour costs represents a significant issue for regulated businesses. ENERGEX considers that as the sole regulator for energy businesses under the national regime the AER has a substantial opportunity to set a cost escalation factor that is industry specific. To this end ENERGEX recommends that the AER establish an industry working group to establish an industry cost escalation index for the escalation of non-labour costs.

ENERGEX considers that the AER's draft decision to set cost escalation away from Powerlink's submission is inconsistent with the AER's stated principles and objectives when setting a revenue cap. In particular, ENERGEX considers that the AER should accept Powerlink's proposed cost escalation factors as it would reflect a more balanced outcome for Powerlink, network users and the long term interests of electricity users because:

- the amount being disallowed ($61 million in the ex-ante capex allowance and $14 million in the controllable opex allowance) is significant to Powerlink in terms of delivering on its proposed network investment but has a marginal impact on Powerlink's maximum allowed revenue; and
- a decision in favour of Powerlink sets a precedent for future regulatory determinations to place the onus on the regulated business to forecast accurately and manage the impact of input cost inflation in accordance with the submitted forecasts.

Other matters

ENERGEX supports in principle the AER's draft decision on the following matters:

- The introduction of a service quality incentive regime (use of a 'caps and collars' regime, where cap is a bonus payment and a collar penalty) for meeting a weighted six performance measure with 1% of Powerlink's annual revenue at risk. In terms of future regulatory decisions, ENERGEX encourages the AER to consider existing service quality standards when setting a service incentive regime.
- The inclusion of the pass through event mechanism based on the Australian Energy Market Commission (AEMC) definition, which includes easement tax change event and a regulatory change event, based on the event resulting in an impact of greater than 1% of annual revenue.
- The opportunity for a revenue cap re-opener where: event not foreseen; in response to the event Powerlink must invest; the project requires capex greater than 5% of Powerlink's RAB in the year of the event; Powerlink can't be reasonably expected to fund (quantum); and there is no existing allowance for the project. ENERGEX notes that for an unforeseen capex project to qualify under this mechanism the forecast cost would need to be greater than $162 million.

If you have any questions regarding this submission please contact Louise Dwyer, Group Manager, Regulatory Affairs, on (07) 3407 4161.

Yours sincerely

T.S Effeney

Terry Effeney
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