EUAA submission on AER Draft Decision
Powerlink response to issues raised

The EUAA submitted a response to the AER's Draft Decision for the Queensland transmission network revenue cap 2007-08 to 2011-12, in which it raised a number of issues. Powerlink is providing a brief response to those issues, and can elaborate if necessary.

• *the implementation of the most economically efficient project alternatives by Powerlink.*

The EUAA indicated two statements in PB's report seemed to be contradictory and inconsistent. The issue identified by PB simply relates to documentation of the reasons for rejection of options which were not economically efficient or were technically infeasible. Powerlink can confirm that there is no risk that the most efficient alternative could be prematurely rejected because feasible options which are close in NPV terms are carried through the full analysis process. Only those which are not close to lowest cost or have technical "showstoppers" are discarded early in the analysis. PB would have liked these options to be formally documented along with the reasons for their rejection to facilitate its scrutiny of the assessment process.

This therefore highlights a documentation improvement opportunity for Powerlink rather than any real risk that the most economically efficient project alternative was not implemented by Powerlink.

• the inclusion of $530M worth of assets "under construction" in Powerlink's Regulatory Asset Base (RAB) accounts for around $46.5M of Powerlink's revenue. This accounts for around 8.7% of Powerlink's annual revenue.

Powerlink agrees with EUAA and also considers that the change in regulatory accounting practice for recognition of capex in its asset based could usefully be deferred to a later time as it increases prices while delivering no reliability benefits to customers. Powerlink has asked the AER to seriously consider this matter in reaching its Final Decision.

• the underspending of the capex allowed in the current regulatory period amounted to almost $10M of excess revenue. This underspend may be repeated, or even increased, due to the very large capex sought;

The regulatory framework which applies to Powerlink's asset base roll forward for the start of the coming regulatory period is the DRP[1]. The AER has made its Draft Decision in accordance with the DRP framework, and has therefore not made any adjustment to Powerlink's closing RAB. In any event, the quantum is immaterial in the context of a closing RAB of $ 3 billion.

In relation to the coming period, Powerlink requires a total capex of about $2.7 billion, or $550 million per year. Unlike the current period where the ramp up in capex spend did not happen until the latter years, Powerlink has already ramped up its capex spend to over $500 million in this financial year, and will therefore start the coming period with a capex spend in line with the sought capex.

• the incentive structure of the regulatory regime provides very weak incentives for the Transmission Network Service Providers (TNSPs) to operate efficiently, while providing TNSPs with opportunities to influence the timing of their capex;

There are both theoretical and practical considerations here. The theory of the incentive framework for the next regulatory period is as per the SRP, which includes the ex-ante capital expenditure framework. This includes an arrangement whereby the TNSP is

[1] ACCC, Draft statement of principles for the regulation of transmission revenues, May 1999.

incentivised to underspend its allowance (set on the basis of efficient forecast expenditure) by allowing the business to retain the return on, and return of, any underspend during the regulatory period. The framework also provides that the amount rolled forward into the asset base for the next period is the actual capex spend rather than the capex allowance. If the capex spend is lower, then customers benefit (ever after) from the lower rolled forward asset base. Thus, the framework seeks to provide a short term benefit to the network in exchange for an enduring benefit for customers. One might expect the EUAA to support such a model.

In practice, Powerlink has to be focussed on timely delivery of investments driven by the compressed timeframes of resource driven development and population/air-conditioning-driven load growth. The capex quantum is also at the mercy of escalating construction costs. Whilst Powerlink does, and will continue to , seek value for money in its capex outlays , in the current environment the capex incentive is necessarily a much lower order issue than timely delivery. This highlights a long term concern of Powerlink's that the theory behind the ex-ante capex framework is based on relatively stable conditions. Queensland is presently the antithesis to that.

• the finding by PB Associates that significant increases in the level of asset replacement was required while the project scope on which the forecast level of expenditure was based was often greater than justified by condition assessments.

PB made this conclusion on the basis of three project assessments across Powerlink's entire bottom up replacement plan. Powerlink considers that PB's conclusion in relation to the scope of these projects in incorrect, and does not recognise the integrated nature of high voltage substations or the operational circumstances and consequences in relation to each project. Powerlink considers PB missed some critical information for each of the three projects, and that this has resulted in an erroneous conclusion about the scope.

Powerlink has provided a detailed explanation in section 2.1.4 of its response to the AER's Draft Decision. For this analysis, Powerlink engaged independent consultants, Evans & Peck, to review the replacement plan and in particular the three projects where PB questioned the scope. Evans & Peck's more comprehensive review concluded that the scope of these three projects was appropriate. Evans & Peck's report on the replacement plan and these three project scopes is presented as Appendix A of Powerlink's response to the AER's Draft Decision.

• Powerlink's capacity to deliver an ambitious capex program over a sustained period.

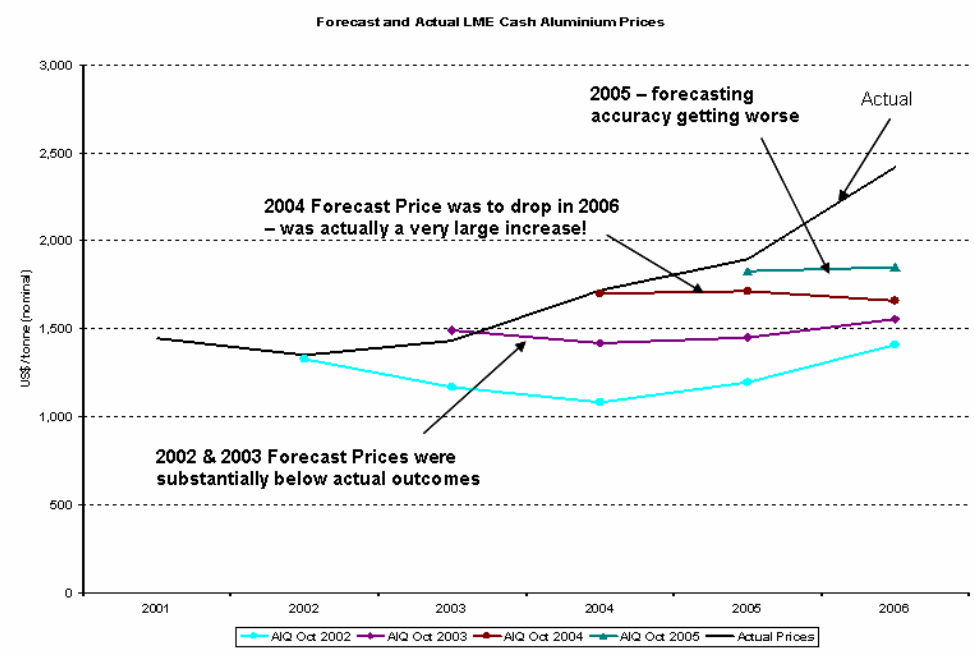
The delivery initiatives which Powerlink has put in place are aimed at ensuring the capital plans can be delivered to maintain reliable electricity supply to Queensland consumers in accordance with Powerlink's obligations. Powerlink has highlighted that, with these initiatives implemented and by meeting Queensland market rates for labour and services, it has been able to ramp up its capital program to a level similar to that required over the coming regulatory period. By way of illustration, the total capex ask of about $2.7 billion equates to an annual average of about $550 million. Powerlink has already ramped up to a capex level of well over $500 million in the current year (2006/07). The forward program includes several large, high dollar value lines projects, so that, in fact, Powerlink will need to deliver fewer projects in future years than it is delivering in 2006/07.

Powerlink continues to have a high degree of confidence in the deliverability of the total capex program, with the only proviso being that Queensland market rates for construction labour and services can continue to be met.

• ignoring the potential for lower commodity prices than used in determining the capex requirement.

The prospect of lower commodity prices needs to be carefully considered in the context of the ex-ante framework and the prices which have actually been used in determining the capex requirement. Powerlink has not used the peak prices which have occurred to date in determining its capex forecast. The actual prices used and the peak price for aluminium are shown here.

In addition, it is clear from history that price forecasters regularly get the prices wrong. Over the past four years the future price of aluminium has been consistently lower than the actual price which has occurred – and by a large margin.



Even if the price of commodities was to fall in US dollars, Powerlink must settle its materials purchases in Australian dollars. In its report to the AER, Access Economics has indicated that the Australian dollar will depreciate in line with any reductions in commodities prices. It is the $A price which is germane, not the $US price.

Given that no one can reliably predict the actual levels of future input costs, and there is no second chance to correct any error under the ex-ante framework, then the AER should take into account the asymmetric outcomes that would impact customers from too little investment in transmission (as lucidly explained in the submission from the Queensland Resources Council) in setting the ex-ante cap.

• the proposed further increase in capex of some $428M in the supplementary submission, amounting to over 17% of the forecast capex requirement provided, just 8 months earlier including:

- *o almost 30% beyond the escalation that should have already been included in its original submission just for assets under construction; and*
- *o a further $125M increase beyond the escalation that was already factored into the capex forecast 8 months ago due to increases in unit rates.*

The combination of the current volatile market for construction costs and changes to critical assumptions, combined with the "no second chance" ex-ante capex framework, has given rise to Powerlink's need to have the matters in the Supplementary Revenue Proposal taken into account by the AER in its Final Decision.

The EUAA submission incorrectly refers to a 30% increase for assets under construction. Powerlink has calculated that the estimated increase in the cost of all projects which are under construction at the transition between the current and next regulatory period as 17%. It is not clear how the EUAA has determined its incorrect figure.

Powerlink has experienced real increases in the costs of its projects since it submitted its original revenue Proposal. Given the ex-ante framework with no second chances, this must be taken into account.

• the acceptance by AER that the new National Electricity Rules for transmission revenue determination developed by the Australian Energy Markets Commission (AEMC) prescribe the Weighted Average Cost of Capital (WACC) parameters to be adopted, leaving the AER with no freedom to adjust the values of these parameters, even if they are found to be wrong.

The AER must make Powerlink's revenue cap decision in accordance with the National Electricity Rules which prescribe the WACC parameters which the AER has (correctly) used in making its Draft Decision. The EUAA is aware that the AEMC has pre-set the timing for a future comprehensive review of the WACC parameters.

• the decision by the AER that it will not update the WACC for the final decision. Such a decision clearly means that the AER will have ignored the most up-to-date data on inflation and interest rates when the final decision is made despite recent indications that these variable will likely be different from those included in the Draft Decision.

The SRP does not preclude the AER and the regulated business pre-agreeing a nominated averaging period for the risk free rate. This is also recognised as appropriate in the new revenue rules. Powerlink agreed the averaging period with the AER that would apply to this revenue decision prior to Powerlink submitting its Revenue Proposal. This allows Powerlink to manage its financing requirements appropriately for a regulated business. As is appropriate, both the risk free rate and the inflation forecast are based on the same averaging period. Having already agreed to this period, it would now be inappropriate for the AER to change its position.

• the indications that Powerlink may be becoming less efficient relative to the other TNSPs. In the three years between 2002/03 and 2004/05 (where the AER has provided comparative opex ratios), while the opex ratios of the other TNSPs (with the exception of Transend) have been generally declining, Powerlink's have been increasing despite the increasing proportion of "new" assets.

The ratios presented in the AER's Draft Decision are based on actual opex, which include in 2004/05 some "one off" costs due to the introduction of the new enterprise bargaining agreement and the commencement of Powerlink's revenue reset preparation. These one off costs have been specifically excluded from the base year data from which the opex forecast was prepared. The ratios for future years maintain the very low levels Powerlink is already achieving. In this regard it should also be noted that it is not possible, in a world of escalating input costs, to achieve further efficiencies in opex from Powerlink's already very low base.

Powerlink believes that it is more likely that other TNSPs are trending towards that "efficiency frontier" than Powerlink retreating. However, rising input costs can move the frontier over time, as experienced by the major mining companies, for example.

• the acceptance that no evidence of double counting of assets or costs has been found when discussing non-regulated activities without detailing the type of non-regulated activities and the basis of the cost allocation.

Powerlink's financial systems separate regulated and non-regulated activities at source. Labour is charged to these activities through time sheets and the labour charge rates incorporate overheads such as facilities, corporate costs, business services, etc. The same labour charge rate is used for regulated and non-regulated activities.

Individual assets are identified as regulated or non-regulated and work, such as maintenance is associated with each asset thereby automatically identifying it as regulated or non-regulated work.

Powerlink has found this system to simply and effectively separate regulated and non-regulated assets and costs. PB and the AER also considered this to be effective.

• the impact on customers of TUoS increases of over 5% pa when inflation is forecast to be 3.15% pa.

Queensland consumers (including those who are members of the EUAA) want a reliable electricity transmission service and are prepared to pay a reasonable price for that service. This was most recently confirmed in the Queensland Resources Council (QRC) submission to the AER Draft Decision:

> *"…the QRC encourages the AER to ensure that any regulatory decisions on Powerlink's revenue cap can consistently deliver the necessary upgrades to the transmission grid to support the capacity expansions in mining, minerals processing, rail and ports within the very tight project timeframes of these export infrastructure chains."*[2]

Powerlink has developed its revenue requirements, and the resultant price impact, on the basis of maintaining a reliable supply to consumers at an efficient price. This is extremely challenging in the current economic environment in Queensland with costs increasing at level well in excess of CPI, indeed well in excess of the TUoS increase of around 5%. Given the Queensland circumstances, the price impact ($3.89 per year for the average customer based on Powerlink's total ask) is considered very reasonable.

[2] Queensland Resources Council, Submission to the AER on Powerlink's Draft Decision, February 2007.