Powerlink submission to ACCC draft decision of the statement of regulatory principles

November 2004

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1 Summary

We welcome this opportunity to comment on the Draft Decision of the new *Statement of Principles for the Regulation of Electricity Transmission Revenues* ("draft SRP") dated 18 August 2004 and the associated Background Paper ("the Background Paper").

In summary:

- The proposed lock-in of the asset base is appropriate, but should be followed by a code change.
- Roll-forwards of the asset base should always be based on actual capex (subject to the incentive mechanism) and actual depreciation. This allows continued alignment between the asset base for regulatory and accounting purposes.
- A capex incentive mechanism can be built based on either capex (as spent) or capitalisations (total cost when assets are in service). The choice need not be prescribed. The SRP should allow the TNSP to propose its preferred approach in its revenue cap application.
- Powerlink considers that if the process to assess prudency of capital investment is clearly defined, an ex-post regime will not result in significant investment uncertainty and it offers the best balance by allowing TNSPs to meet their mandated statutory obligations whilst ensuring that customers are not overpaying for this service.
- Notwithstanding the last point, Powerlink does not have an in-principle objection to an ex-ante capex framework. However, the proposed implementation is unacceptable when applied to Powerlink's network development risk profile.
- The capex framework should allow a number of risk/benefit models that can be selected according to the specific environment that the TNSP believes is appropriate to its circumstances and risk appetite.

- Powerlink believes that for Queensland a more appropriate ex-ante capex framework would have symmetric benefits and losses around the target. Annual charges associated with capex benefits / losses are fully passed through to the TNSP for 5 years from the date they are incurred. After that period, they pass through to customers. This should be one of the risk/benefit model options available.

- Powerlink further proposes that the SRP also include the ACCC proposed asymmetric scheme as this may be appropriate to the risk profile of other TNSPs. TNSPs should have the opportunity to select the applicable capex incentive scheme in their revenue reset application.

- Exclusions from the ex-ante cap should be left to the discretion of the TNSP to nominate, rather than to a complex equation with unconvincing statistical rigor and it should allow for classes of exclusions due to projects which are not known at the time of the forecast.

- The 5% threshold for off-ramps is unacceptable ($50m for Powerlink). By its nature, the threshold for off-ramps should be set to 0% and therefore more appropriate as a pass-through event.

- The SRP is missing a discussion on the application and purpose of the regulatory test for projects within the ex-ante cap methodology.

- Powerlink broadly supports the opex incentive scheme but cannot accept the carry-forward of losses as currently proposed.

- The extension of the revenue review process to 12 months is appropriate and the proposed process for managing late submissions is an improvement to the existing process.

- The ACCC view of confidentiality is simplistic and does not recognise the very real issues that this presents to TNSPs.

2 Introduction

Powerlink welcomes this opportunity to contribute to the development of the new Statement of Regulatory Principles. This is an important document for providing guidance as to how the ACCC will treat future revenue determinations. For incentive regulation to be successful, TNSPs must have certainty of the treatment of efficiency gains.

Consistent with the code provisions the ACCC states in the draft SRP that:

> *An objective of the regulatory regime is to provide certainty and consistency for TNSPs and users.*

and that:

> *An objective of the regulatory regime is to foster efficient investment and operating practices within the transmission sector, and to provide for an equitable allocation between TNSPs and users of expected efficiency gains.*

Powerlink notes that the ACCC has invested significant effort in clarifying its approach to regulation and identifying the information requirements. In this sense, the draft SRP and Background Paper provide a good step forward.

However, Powerlink has significant concerns over the current proposals for treatment of capital investment. In particular, the very real risk that prudent and efficient investment is not allowed to be recovered simply because it was not forecast up to 7 years ahead of time.

As we have commented in previous submissions, transmission entities like Powerlink operate in an environment of mandated statutory obligations, accompanied by onerous liabilities and financial exposures which reflect the high value placed by the community on a secure and reliable transmission grid fit for a modern, digital economy.[1]

The vast majority of our capital investment is driven by this need and is thus **not discretionary**.

[1] Refer to Powerlink's submission to the ACCC supplementary discussion paper on the capital expenditure framework, April 2004.

This submission has been written with the aim of ensuring that through the application of the regulatory principles embodied in the Statement of Regulatory Principles, Powerlink will be able to meet its mandated statutory obligations and receive appropriate compensation for its costs and a commercial return for doing so as is required by clause 6.2.2 of the Code.

Consequently, this submission largely focuses on this aspect of the regulatory principles and other associated issues, such as asset base roll-forward, that cannot be considered in isolation. We do however make comments on other aspects of the draft SRP broadly following the structure of the draft SRP and the Background Paper.

3 Regulatory Framework

In our response to the ACCC Discussion Paper *Review of the Draft Statement of Principles for the Regulation of Transmission Revenues* we noted that continued development of the regulatory framework effectively perpetuated the regulatory uncertainty faced by a TNSP and consequently the risks on the business. This is true irrespective of the intent of the ACCC in developing the framework. We therefore cautioned that:

> *the ACCC must impose a "very high hurdle" in adopting any changes to the regulatory environment.*[2]

We maintain that any changes to the regulatory principles and framework must be demonstrated to facilitate improvements in the process or predictability of the regulatory outcome before being accepted. Specifically, we believe that the principles must recognise explicitly, as an objective and in the provisions of the building blocks, that **security standards are sacrosanct for a TNSP and revenues must be set at a level that first and foremost allows the TNSP to comply efficiently with the security standards**.

Notwithstanding this, Powerlink agrees in principal with the proposed framework insomuch that it retains the building block approach whilst developing the incentives on operating costs and capital expenditure. We believe that this

[2] Powerlink, *Powerlink Submission to ACCC Discussion Paper on the Review of the Draft Statement of Regulatory Principles*, November 2003

provides a better understanding of what would be expected of a TNSP in a revenue reset application and therefore provides greater certainty for the TNSP and other interested parties going forward.

However, although we welcome the increased information with respect to the regulatory principles, as noted above we have significant concerns about the detailed proposals, and particularly with the incentive arrangements for capital expenditure. These issues are addressed in detail in the following sections.

4 Revenue Cap Decision Making Process

4.1 Process

We agree with the ACCC's proposal in respect to the revised timescale for a regulatory reset application and review. We believe that the 12 month programme, together with the revised consultation timescales and process for late submissions will facilitate more timely and efficient reviews. In particular, we believe that the process identified for late submissions is appropriate and will facilitate more control over the timescales of future reviews.

We also welcome the ACCC's work to clarify the type and level of data expected to be submitted by a TNSP with the application. However, we would urge the ACCC to recognise that data will necessarily be forecast for the remainder of the current period in which the application is made (typically two forecast years). Therefore it is necessary for the ACCC to acknowledge that revised data will be accepted when the audited accounts become available for the penultimate year of the regulatory period. The final year will always be a forecast year.

As currently written, the ACCC have allowed any interested party to call for a public forum:

> *"Any interested party who wishes to comment on the ACCC's Draft Decision may request a public forum within two weeks of the release of the Draft Decision."*[3]

We feel that the process for requesting a forum should be formalised with the party requesting the forum required to provide detail why a forum would benefit

the process. Further, we also believe that the value of the forum would be enhanced by providing the opportunity to ask the ACCC questions on the draft decision.

4.2 Confidentiality

We do not believe that the ACCC has recognised sufficiently that confidentiality is a legitimate concern for TNSPs within a revenue review. For example, assumptions in forecast expenditure relating to sensitive data on projected salaries and suppliers' costs can have a serious detrimental effect on the ability for the TNSP to negotiate an efficient and cost effective position. This is damaging to both the TNSP and ultimately its customers.

We reiterate our comment made in our response to the discussion paper that:

> *"Ultimately, the proposals on confidentiality requirements could lead to a stark choice of making confidential information public or risking revenue by being forced to rely on a weakened argument, which potentially penalises the TNSP for making prudent commercial arrangements."*[4]

Further, we do not believe it is necessary that the detailed information provided in response to consultants' assessments is made public. The purpose of the consultants' assessment is to obtain a third party expert opinion on the appropriateness of the levels of expenditure forecast by the TNSP. In carrying out this function it is often necessary to provide an extensive amount of detailed supporting data that, whilst useful in informing the consultants' views, provides no meaningful assistance to the public debate.

To such extent, we understand the desire of the ACCC to make sufficient information available publicly to allow meaningful debate to take place and would expect our application and various information requirements to be made public. In particular, we would only expect the publication of broad historical reconciliations between actual expenditure and the regulatory allowance.

[3] ACCC Draft Decision, *Statement of Principles for the Regulation of Electricity Transmission Revenues – Background Paper,* August 2004
[4] Powerlink, *Powerlink Submission to ACCC Discussion Paper on the Review of the Draft Statement of Regulatory Principles*, November 2003

However, we believe that the principles should recognise that it is appropriate for certain data (such as the highly detailed expenditure and project data) to be kept confidential and withheld from the public domain. The current proposal, although allowing for specific exclusions, does not in our view recognise this principle.

5 Asset Base

We understand the ACCC's desire to lock-in the asset base and adopt a roll-forward approach to the asset base. Such an approach will lead to greater certainty for TNSPs, their investors and customers. As noted in our submission to the August 2003 Discussion Paper *"TNSPs have never been recompensed for the risk associated with the subjectivity of revaluations and the potential loss of recognition of some prudently incurred capital investment."*

In that submission, Powerlink called for a balanced approach considering the pragmatic trade-offs of all aspects of the regulatory principles rather than creating opportunities for "cherry picking" individual elements.

Therefore, to the extent that revaluation risk is still not considered in the WACC, Powerlink supports the approach of locking-in the sunk asset base. However, it is essential that this approach is binding and therefore a change to the Code should be effected.

5.1 Roll-forward mechanism

We believe that the mechanism for rolling forward the asset base needs further development. Powerlink offers the following comments and would welcome the opportunity to further discuss this important modelling aspect.

The general asset base roll-forward equation is:

Closing RAB = Opening RAB + capital investment – depreciation + indexation using actual CPI

Powerlink understands that there are various choices:

- Capital investment could be capex (i.e. on an annual as spent basis) or capitalisations (i.e. total costs carried forward to the time assets are brought into service)

- Depreciation could be the depreciation allowance in the revenue cap or the actual depreciation based on actual capital expenditure / capitalisations

Powerlink believes that, from a regulatory modelling point of view, there is no difference between the different approaches. Models can be constructed that provide the same present value under any of these choices. This view is supported by the ACCC in the Background Paper[5] and by Allen Consulting in their paper to the ACCC[6].

To the extent that regulatory models can be constructed with any of the above options, **the choice should not be prescribed but allowed to suit the individual circumstances of the TNSP in question**.

Powerlink has a strong preference for the use of actual capital investment (in the form of capitalisations) and actual depreciation. Our reasons for this have been more fully set out in our submission to the ACCC's August 2003 Discussion Paper but briefly are:

- Simplicity: to be consistent with accounting standards, depreciation needs to be calculated from capitalised amounts (i.e. when assets are in service) so a model that uses capex as spent would still need to consider capitalisations (as commissioned)

- Transparency: this information is already provided in the annual regulatory accounts and the asset roll-forward can be easily be tracked every year from the information in these accounts

- Minimises costs: consistency with accounting requirements allows continued alignment between the regulatory asset base and the financial accounting asset register. Other treatments for Powerlink would result in, at best, having to perform complicated adjustments at the end of the regulatory

[5] Refer, for example, to section 4.6 (a) of the Background Paper, p. 68
[6] Allen Consulting, *Methodology for Updating the Regulatory Value of Electricity Transmission Assets* (August 2003, p.32)

period or possibly even the departure of this consistency and the need to keep a separate set of books for regulatory purposes.

If the ACCC chooses to prescribe the treatment and does not adopt actual capitalisations and actual depreciation, it is Powerlink's view that there needs to be very compelling benefits as it would significantly increase compliance costs and complexity.

If capex (as spent) is adopted

If capex (as spent) is adopted in the next regulatory period, then there is a requirement to roll-forward capex spent in the current regulatory period which is not yet commissioned in the calculation of the opening RAB. Consistent with other treatments, the post-tax WACC needs to be used to carry forward the value to the opening RAB.

Capitalisations drive depreciation, which is a clear accounting standard, i.e. only assets that have been commissioned may be depreciated. This will necessitate the provision of a capitalisation forecast, in addition to a capex forecast, to calculate the required depreciation allowance for future periods.

Incentive scheme amounts

The asset-base roll-forward equations in the draft SRP include the capex incentive scheme. However, like the opex incentive scheme, the capex incentive scheme should be a separate revenue item and not added to the RAB. This is also consistent with the treatment of capex efficiencies under the existing regime.

CPI indexation of the asset base

In revenue cap decisions to date, the ACCC has treated the CPI indexation of the asset base implicitly within the depreciation calculation – termed *economic depreciation*. This is also embodied within the Post-Tax Revenue Model.

The draft SRP as currently drafted is silent on the treatment of CPI indexation of the asset base. Further, section 4.3 of the draft SRP states that *"the ACCC will determine the opening RAB for the regulatory period based on actual inflation."*

Powerlink believes that CPI escalation of the asset base should be explicitly and clearly covered in the final SRP.

5.2 Roll-forward under ex-post and ex-ante regimes

When discussing the roll-forward from the opening RAB to the closing RAB, it is essential to distinguish between the mechanism that applies under an ex-post and an ex-ante capex framework.

Ex-post framework

Section 4.3 of the draft SRP sets out the proposed roll-forward under the ex-post regime. The following are Powerlink's comments on this section:

- As per our comments above, we consider that actual depreciation should be used instead of the depreciation allowance.
- The capex incentive scheme has to date been treated as a cash flow item and Powerlink considers that a cash flow allowance is the appropriate treatment.
- As per our comments above, CPI indexation should be clearly addressed. It is partly discussed on page 68 of the Background Paper and it should be added and clearly described in the final SRP.

Additionally, the foregone return on and depreciation due to prudent and efficient capital investment above the allowance should also be discussed. Step 2 on page 68 of the Background Paper discusses *the adjustment of the RAB to account for differences between forecast and out-turn efficient capex including the foregone return on capital on the difference*.

To the extent that this foregone return is a 'missing' cash flow because of forecast error, Powerlink considers that the present value of the foregone return and depreciation should be provided as a cash flow allowance at the next regulatory control period and not rolled into the RAB.

Ex-ante framework

It is clear from the discussion of the incentive mechanism for the ex-ante framework that the asset roll-forward should be based on actual capital investment[7] and actual depreciation. The return on and of capital that results from any capex underspends would be retained by the business as an efficiency benefit. Users then see the benefits of the under-spend at the next regulatory period.

Under the symmetric capex scheme that Powerlink proposes in section 6.1, efficiency losses due to overspends would also be treated in a symmetrical way.

Further if a carry-forward of benefits/losses is adopted (as per section 6 of this submission), these would be required as a separate cash flow item in the revenue cap of the following regulatory period.

5.3 Depreciation

In the past, TNSPs have been unable to fully reconcile the ACCC's calculation of depreciation. The situation was not helped by the ACCC not having a financial model that it was willing to share with the TNSP.

While this situation will now be improved with the development of the PTRM and the sharing of models with the TNSP, Powerlink believes that a further improvement can be made with regard to depreciation.

Powerlink believes that the TNSP's application should include the depreciation profile that applies to the opening RAB at the start of the regulatory period. This depreciation profile would be calculated using the TNSP's internal financial systems from a full asset register (provided that the roll-forward mechanism allows the financial accounting asset register to remain aligned with the regulatory asset base). The ACCC and its consultants can then verify the accuracy of the depreciation profile. This should not be a controversial exercise as there is no opportunity for gain by the TNSP.

Once the depreciation for sunk assets has been set, any material changes between the depreciation allowance and the actual depreciation should only be due to

[7] Up to the cap for the asymmetric model for projects within the cap, and always for excluded projects and under a symmetric model

differences in inflation and differences between the capex/capitalisations forecast and actual capex/capitalisations (either in total amount or the asset mix).

This has the advantage that depreciation differences can now be considered at the high level for the capex incentive mechanism (provided the analysis is done to remove the inflation differences – i.e. in real dollar terms).

5.4 Post-Tax Revenue Model

Powerlink is aware of the significant effort that the ACCC has employed in developing its Post-Tax Revenue Model (PTRM).

Powerlink believes that the publication of the model is very useful for transparency of revenue decisions. In particular, sharing the model between the ACCC and the TNSP being reviewed helps to eliminate debate on modelling details and allows focus on more fundamental issues.

Powerlink strongly supports the further development and publication of the PTRM and believes that it needs to contain all the modelling required for the asset-base roll-forward.

6 Incentive Arrangement for Capital Expenditure

The ACCC has been developing a framework for capital investment that relies on ex-ante forecasts rather than an ex-post review of prudent investment.

Powerlink still believes that the existing ex-post capex framework delivers the best balance by allowing TNSPs to meet their mandated statutory obligations and ensuring that customers are not overpaying for this service. We believe that an ex-post review is not necessarily any more intrusive and time consuming than setting an ex-ante target, provided that the information requirements that the ACCC expects from the TNSP are *clearly defined*. Furthermore, if the process to assess prudency of capital projects is clearly defined, an ex-post regime will not result in significant investment uncertainty.

Notwithstanding this, Powerlink is not fundamentally opposed with an ex-ante capex framework provided that it contains the necessary properties that all

prudent investment will be eventually recognised and that the process does not add delays and prevent the timely delivery of reliability. Additionally, we support the following characteristics:

- The ACCC approves an allowance for most of the required capital investment before the start of the regulatory control period
- The scheme does not create significant road blocks that would prevent timely provision of works to meet mandated statutory obligations
- The allowance is based on a probabilistic analysis of requirements during the regulatory period
- There is a provision for the automatic adjustment of the allowance subject to observed changes in the environment (eg load growth outcomes)
- There is no further adjustment to revenues during the period for capex within this allowance
- TNSPs can choose the actual projects carried out within the regulatory control period
- There is no ex-post review of actual projects carried out
- There is an *equitable* sharing of benefits and losses between TNSPs and customers at the next regulatory period
- Some projects (or classes of projects) are excluded from the above treatment and instead are subject to a project-specific treatment
- There is provision for off-ramps for events that are outside the scopes of forecasts

However, Powerlink cannot accept the detailed proposals for the incentive arrangement for capital expenditure in the draft SRP. In particular, as detailed below, we are concerned that efficient and prudent investment would never be recovered if it was failed to be properly forecast up to 7 years ahead of time or not allowed by the ACCC in the capex target.

The ex-post framework does not suffer from this difficulty. We believe that an adjustment to the ex-ante framework as proposed by Powerlink would make it workable for Powerlink's specific risk profile.

6.1 An appropriate ex-ante framework for Powerlink's risk profile

Powerlink proposes that the SRP include at least two separate ex-ante frameworks. The appropriate framework would be selected by the TNSP in its revenue cap application according to its specific risk profile. The risk profile is affected by the inherent variability and uncertainty and the capability of the TNSP to deal with such, as well as the extent to which mechanisms such as the formularised cap and off-ramps are able to protect the TNSP from this uncertainty and variability. The two frameworks are:

- One where the benefits and losses are shared symmetrically;
- One where the target is set more conservatively (higher) but there is an asymmetric sharing of benefits and losses (as described in the draft SRP).

In either case, we believe that a 5-year carry-forward incentive mechanism should apply based on the return on and return of any under and overspends. This provides constant incentives over time. Like opex incentives, the carry-forward capex incentive amounts should be kept as a separate cash flow line in the revenue cap decision rather than being capitalised through the asset-base roll-forward.

For Powerlink's risk profile, a symmetrical framework with a carry-forward mechanism would provide sufficient incentives not to overspend. However, it still provides the opportunity to recover some of the costs should the situation arise where it is necessary to overspend in order to meet our statutory obligations.

6.2 Forecasting

Currently, TNSPs face the asymmetric risk of optimisation for which we are not receiving appropriate remuneration. However, the existing regime does allow for

TNSPs to demonstrate that their investment was prudent – *once all the facts are known*.

The task of demonstrating that the *forecast* is prudent is a much greater challenge. At the time the forecast is developed there is uncertainty in: (a) whether or not drivers for investment will be present at all, (b) the magnitude of the driver and (c) the timing of the driver. Additionally, there is the risk of demonstrating that we have selected the appropriate option to address the need. And even when this is done, TNSPs have to estimate the cost of implementing this option taking into account potential changes in input costs (such as exchange rates, prices of aluminium, etc) 7 years out!

This adds significant risk to TNSPs that needs to be addressed. Unless the WACC includes an appropriate risk premium, the forecast for any ex-ante scheme will need to be very conservative.

Additionally, however, if the penalty for spending over the target is severe, the overall cap needs to be high enough as to include the costs of efficiently meeting our statutory obligations under any possible future scenario – not just based on average expectations or even adding a bit to the average.

We acknowledge that the forecasting task is more challenging for Powerlink's environment than perhaps for other TNSPs. This is because of our high proportion of augmentation capex compared to asset replacements and because of the volatility of the load growth in Queensland.

6.3 Setting the ex-ante target

The ACCC state that they do not believe that establishing an ex-ante target will require the same level of intrusive analysis as the current ex-post regime. However, they go on to state that

> *"In general, in conducting such probabilistic assessments it is important to have a clear understanding (and to be able to clearly communicate):*
>
> …

> *how the resulting investment in response to different load flows has been estimated, i.e. specification, cost, timing etc. and justification of all the projects that are deemed to be needed to respond to the expected new load flows"*[8]

This implies that the ACCC expects the same level of justification of individual projects that is currently required in the ex-post review, in addition to the analysis of probabilistic forecasts. The information requirements identified in Appendix A further support this interpretation. It is essential that the ACCC clarify what level of detail it expects in justification of an ex-ante target and that the required level of detail be realistic and achievable given the very large number of projects and long lead times required for a 5-year regulatory submission.

The current indication is that the level of detail needed is in excess of the current requirements in conducting an ex-post review. This is clearly undesirable for the TNSP as the documentation provided to justify expenditure in an ex-post review is generated over the 5 year regulatory period; for an ex-ante review the supporting documentation required would have to be generated within the timescales of the application, approximately 1 year. This imposes further regulatory inefficiencies and risks on the process.

6.4 Excluded projects

Powerlink supports the concept of excluding some projects or class of projects from the ex-ante target. However, we consider that the mechanistic exclusion rule, while on face value theoretically attractive should not be the only way that excluded projects are selected. We strongly support the ACCC's statement in section 5.3 of the draft SRP:

> *"The TNSP can apply to the ACCC for specific projects to be excluded from the ex-ante cap, even where this value threshold is not satisfied."*

The ACCC goes on to say:

> *"Projects excluded from the ex-ante cap must be linked to unique investment drivers – such as a major point load or expected power station – rather than to general investment drivers (such as expectations of load growth within a region)."*

[8] ACCC Draft Decision, *Statement of Principles for the Regulation of Electricity Transmission Revenues – Background Paper,* August 2004

Powerlink considers that the application of excluded projects should be broadened to include a "class" of projects driven by specific investment drivers but where the specific project is not known at the time of the forecast. For example, it is possible that a new major point load that is not known at the time of the forecast eventuates within the 7-year forecast timeframe. The actual excluded projects would be reviewed using the full Regulatory Test on a case-by-case basis to ensure that they are prudent and that they were not covered by the ex-ante target forecast. This eliminates the opportunity for "double dipping".

Powerlink agrees with the ACCC that a 'budget' allowance will be required for excluded projects during the revenue reset. An adjustment can then be made in the next revenue reset after the full costs of the project are known.

As regards compensation for the foregone return, p 69 of the Background Paper suggests that this should be added to the asset base at the next regulatory period.

For the reasons outlined above, Powerlink believes that this is more appropriately handled through a cash flow item in the revenue cap. In addition, there will need to be a cash flow allowance made to the TNSP for the 'foregone' depreciation between commissioning and the time the assets roll forward into the RAB. This item is missing from the discussion in section 4.6 of the Background Paper and would need to be added to the final SRP.

6.5 Off Ramps

With the proposal for defining certain exogenous events that trigger an off-ramp, the ACCC state that only where the impact of the event amounts to over 5% the TNSP capex allowance would this be recoverable from the consumer. For Powerlink, this could amount to some $50m, which means that Powerlink must shoulder a disproportionate amount of risk for little or no opportunity to gain a reward.

In subsequent discussions, the ACCC appear to have relaxed this threshold to 5% of the **annual** capex allowance for the year in which the event occurs. This is a lower risk threshold and limits the exposure of a TNSP to windfall losses.

However, if the events that can trigger an off-ramp need to be clearly and specifically defined, Powerlink does not believe that there should be a need to have a threshold at all in order to limit the number of claims received by the ACCC.

Powerlink therefore believes that a 0% threshold is more appropriate if events are to be specifically defined or, alternatively, a materiality threshold could be applied if the off-ramp definition is broad. In the latter case, the TNSP would need to demonstrate that the out-turn event was outside of the scope of the capex forecast in order to be treated as an off-ramp event and that the magnitude of the rectification action will be greater than the materiality threshold.

We would also like the ACCC to acknowledge that in the unlikely situation of multiple events, these would be considered together, in that if several events occurred that individually fell below the threshold but that together it would trigger an off-ramp.

In addition, the proposed mechanism for off-ramps precludes the possibility of recovering necessary additional expenditure within the period in which it was incurred. The ACCC state that:

> *"Invoking the "off-ramps" mechanism is unlikely to qualify as one of these circumstances. This means that if the ACCC expresses a view on an allowance for investment following an "off-ramps" events, there is no mechanism for this allowance to be included in regulated charges during the regulatory period in which the event occurs."*[9]

We do not agree with this view. The proposed off-ramps are effectively pass-throughs for capital expenditure. Indeed the ACCC state that pass-throughs currently cover necessary capital expenditure as well as operating costs for certain scenarios.

> *"For example, under the pass through rules as currently drafted, the MAR is adjusted for expenditure (capital or otherwise) arising from a terrorist attack."*[10]

[9] ACCC Draft Decision, *Statement of Principles for the Regulation of Electricity Transmission Revenues – Background Paper,* August 2004
[10] Ibid

Therefore, it is unreasonable to treat capex pass-throughs differently to opex pass throughs. There may be merit in combining all such issues into a single set of pass through rules which are blind to whether the financial impact is additional operating costs or capital expenditure. Either way it is right and appropriate to allow in period amendments to revenues to cover for such events.

In summary, Powerlink believes that a 0% threshold should apply or that off-ramps should simply be treated as pass-throughs where the TNSP demonstrates that the event was outside of the scope of the capex forecast. In any case, an in-period adjustment is appropriate.

6.6 Regulatory Test

In the supplementary discussion paper, the ACCC state:

> *"In a framework where a firm cap is set and there are no ex-post reviews of the efficiency of individual projects, the role of the regulatory test is brought into question."*
>
> *"The regulatory test could be amended to become more a consultative tool for projects within the firm ex ante cap... However, it would no longer rank the various alternative projects."*[11]

Furthermore, in the final decision on the amendments to the regulatory test, the ACCC deferred a couple of issues on the mechanism and application of the regulatory test. Specifically, the ACCC stated that:

> *"The framework in which the test operates, and its use by the ACCC in setting a Transmission Network Service Provider's (TNSP) capital expenditure allowance, is addressed in the Statement of Regulatory Principles and is not addressed in this Decision."*
>
> *"On the issue of the thresholds for new small network asset and new large network assets, the ACCC considers that this is best addressed as part of the review of the Statement of Regulatory Principles."*[12]

[11] ACCC Supplementary Discussion Paper, *Review of the Draft Statement of Principles for the Regulation of Transmission Revenues - Capital Expenditure Framework*, March 2004
[12] ACCC Final Decision, *Review of the Regulatory Test for Network Augmentations*, August 2004

It is therefore unacceptable that there is no clarification of the role of the regulatory test in the draft decision, either relating to the application of the test to projects within the firm ex ante cap or the threshold value to which it applied. This is a critical issue and we believe must be incorporated into the final statement of regulatory principles. We would appreciate the opportunity to comment upon the ACCC's proposal on when and how the regulatory test must be applied.

We believe that the economic assessment of options under an ex ante regime is inappropriate as the incentive is already strong not to overspend the allowance. This will therefore drive the TNSP to select the most cost efficient solution to any network limitations. However, we acknowledge the need to retain the informational content of the regulatory test and would propose that the Code provisions be amended such that appropriate information be provided in the Annual Planning Report.

7 Operating & Maintenance Expenditure

7.1 Benchmarking

We support the ACCC's proposed approach to setting future allowances for operating costs and benchmarking. We believe that in the absence of proven and consistent benchmark data it is appropriate to continue to set operating cost allowances based upon a TNSP's historical and forecast expenditure, taking into account endogenous and exogenous factors on the forecast expenditure. We would also recommend that any such allowance recognise the increased pressure to deliver efficiency whilst maintaining, or improving, the service level offered to customers. It is imperative that the opex allowance does not place unreasonable pressure on this balance, ultimately at the expense of service level.

Powerlink has consistently demonstrated excellence in independent benchmarking studies and believes that it is one of the most cost efficient transmission companies in the world. This has not been without considerable additional effort and risk. As such, there is a strong case for more efficient TNSPs to be incentivised for this efficiency through the adoption of a benchmarking scheme. However, we

recognise that implementing a suitable benchmark to compare TNSPs meaningfully will have difficulties due to the small population of appropriate peers and the variations in operating environments. We therefore welcome the formation of a working group to investigate the potential to develop suitable industry wide benchmarks and look forward to contributing to the development of an appropriate benchmarking methodology.

7.2 Incentive arrangements

We agree with the principle that TNSPs should be allowed to retain efficiency gains for a full 5 years to ensure that the incentive is time-independent. However, we note that an essential component of the proposal is ensuring that the benefit from any carry forward mechanism is maintained through the subsequent period. Consequently we agree with the ACCC's proposal to make the benefit neutral to inflation. However, the ACCC has not committed to illustrating how forecast opex allowances will be set. This raises the spectre of random and inappropriate 'efficiency targets', which in the absence of any quantitative benchmark data, is effectively a claw back of previous efficiencies, which erodes the benefit carried forward and hence the incentive to improve efficiency.

Consequently, Powerlink cannot accept the carry forward of losses under such a possibility as that would constitute a 'double penalty' – the lowering of the baseline targets with the carry-forward of a loss laid on top. Any carry-forward of losses in this situation reduces the amount of revenues available to the TNSP below that which the ACCC has deemed necessary for the provision of services.

It should also be noted that when companies have already picked the low hanging fruit, the potential for overspend is greater than the opportunities to find efficiencies. This mechanism therefore discriminates against already efficient operators.

It is clear that the mechanism works well for underspends and will deliver benefits to customers. However, it is less clear that a change in baseline will be equitably shared. Powerlink proposes that the ACCC does not carry-forward losses unless it sets out a principle that events that have led to the overspend will be allowed in future opex allowances.

Treatment of carry-forward amounts

Section 6.4 of the draft SRP appears to treat the carry-forward amounts from the efficiency benefit from the previous regulatory control period as a component of the opex allowance. As this is an additional return to the business for efficiency benefits, Powerlink considers that it is more appropriate for this to be a separate line in the revenue cap to avoid confusion on comparisons with actual expenditure.

7.3 Self-Insurance

The concept of the self-insurance in the draft SRP is contrary to Powerlink's understanding of this insurance option. Powerlink has always maintained that the self-insurance principles are those of price shock avoidance, in that if an event was to occur, previous allowances would be used to offset the cost and any residual amount passed through to the customers. The mechanism that the ACCC describes places an unreasonable level of risk upon the TNSP, which is not an insurance company.

It should be noted that many events that could be covered through self-insurance are uninsurable in the market and it is therefore inappropriate to place such additional risk upon the TNSP where there is no alternative to self-insurance.

We understand that the ACCC will soon be issuing a discussion paper on "self-insurance" principles and arrangements. Powerlink reserves its comments on self-insurance until this paper is distributed.

7.4 Pass-Throughs

We agree that specific pass through rules should be agreed as part of the revenue review process so as to make appropriate consideration in the context of other provisions within the revenue cap. We also agree that it would be useful for the ACCC to have a set of "standard" rules as a starting point. However, Powerlink cannot comment on the content of the "standard" set of pass-through rules as we have not had an opportunity to review them.

8 The Weighted Average Cost of Capital

We acknowledge the steps that the ACCC has taken to clarify the assumptions that they will use with respect to estimating the appropriate WACC for a TNSP. Drawing a 'line in the sand' represents a significant step forward and a saving in the public debate of the appropriateness of these components that, pragmatically, should actually compare the total estimate against the minimum margin above the risk free rate that would be expected to encourage discretionary investment.

Having said that, suggestions that the ACCC could change the value of parameters at any time erodes the value of regulatory certainty. We believe that the ACCC can retain its discretion and improve certainty by:

1. Stating that there is a high-hurdle for any changes to parameters. That is, evidence must be very compelling that the current parameters do not lie within the reasonable range supported by robust evidence; and

2. In any case, reviewing these parameters once only per round of revenue resets.

Risk free rate

We welcome the ACCC's decision to use the 10-year government bond rate as a proxy for the risk free rate. This is the most relevant rate for long-lived transmission assets that is independent, unequivocal and easily available. We also support the proposal that a TNSP may elect the length of averaging period, between 5 and 40 days, for calculating the risk free rate.

Market Risk Premium

We agree with the ACCC's view that comparison of the MRP in Australian decisions to those in other markets internationally is inappropriate due to the segmentation of the international markets. In the absence of more accurate data and in order to promote regulatory certainty, the ACCC's approach of adopting an estimate of 6% is appropriate.

Equity Beta

We support the ACCC's proposal to apply an equity beta of 1.0 given the lack of consistently reliable quantitative market data to support any other value. This would mark consistency in the regulatory regime, and as such it should be stated clearly that any change to the value would be subject to consultation on the statistical methods proposed.

We would also point out that, as demonstrated by NERA in their paper *Evaluation of the ACCC's Proposed Approach to Statistical Estimation of Equity Betas for TNSPs*, when the ACCC's statistical analysis is adjusted for errors with regard to the upper bound estimate chosen, it results in an equity beta that is not statistically significantly different from 1, which has been adopted by the ACCC to date.

Cost of Debt

With respect to the cost of debt, we support the use of the 10-year government bond as a proxy for the risk free rate, together with an assumed debt term of 10 years.

However, we believe that the proposed benchmark credit rating for a TNSP of "A" undervalues the cost of debt and is inconsistent with the requirements of the Code, namely:

> *"The weighted average cost of capital is a "forward looking" weighted average cost of debt and equity for a commercial business entity. Accordingly, the Network Owner's weighted average cost of capital will represent the shadow price or social opportunity cost of capital as measured by the rate of return required by investors in a* ***privately-owned company*** *with a risk profile similar to that of the network company."*[13]

The sample of companies selected by the ACCC in evaluating a benchmark credit rating is dominated by the number of Government-owned companies. This acts to distort the credit rating, resulting in a higher rating than is appropriate which impacts upon the WACC allowed.

Also, it should be recognised by the ACCC that a TNSP faces interest rate risk for borrowings during the regulatory period and in periods where borrowing has

necessarily been increased to meet the capital investment necessary to meet higher than expected demand growth.

Gearing Ratio

For regulatory consistency, we support the use of a benchmark gearing ratio for TNSPs of 60%.

Gamma

Empirical evidence indicates that the ACCC's value of 0.5 is at the upper end of adopted gamma values, and as such there is no justification for a gamma less then the 0.5 used in previous regulatory decisions. Rather there is a case to reduce the value for gamma. However, for regulatory consistency, we support the use of a benchmark value of 0.5 for gamma.

Debt & Equity Raising Costs

The debt raising costs are an integral part of the debt margin and should be included in the estimate of WACC. However, we recognise that the overriding principle is for a TNSP to recover the efficient costs; the method of which is less important. Consequently, although we believe in the principle that these costs should form part of the debt margin, a TNSP will be neutral to the way that the costs are recovered, provided that the benchmarks are accurate.

We agree with the ACCC's proposed treatment of equity raising costs.

9 Financial Indicators

We recognise and support the desire of the ACCC to utilise financial indicators as a guide to the appropriateness of their regulatory decisions. It is important that such indicators are only used as a guide and in no way form the basis of any benchmarking between companies – even endogenous benchmarking with historical data will be inaccurate due to changes to the structure of a company over time.

[13] National Electricity Code, Schedule 6.1

Furthermore, it is essential that the ACCC publish the outcomes of its financial indicator analysis and the basis it believes will satisfy the benchmark credit rating.

10 Information Requirements

We support the ACCC's intention to clarify the data requirements for an application and agree that the precise content of any application, and any subsequent information requests, will depend on the circumstances and be determined on a case-by-case basis.

The guidance included in appendix A on the type and quality of data to be submitted appears to us appropriate and in line with what we would expect to provide with a reset application.

However, we would note that the information requirements for past capital expenditure in appendix A.3 only apply for an ex-post assessment. Consistent with statements elsewhere in the draft SRP, it would be inappropriate to require this level of information under an ex-ante framework. We consider that this should be clarified in the final SRP.

We would also point out that the project specific information for forecast capital expenditure is likely to be sparse, particularly in the later years. Given the probabilistic approach to forecasting reliability projects it is not appropriate to highlight a list of projects that would make up the firm cap of capital projects. Indeed, the ACCC recognise this earlier in the paper, stating:

> *"The cap, however, does not entail project-specific approval and there will [be] no constraint on TNSPs investing in different projects to those included in the calculation of the cap."*[14]

In addition to the information suggested in appendix A, we would expect to provide detailed information on an adjustment mechanism to account for variations in the capital expenditure drivers, such as demand growth, as described by the ACCC earlier in the draft SRP (section 5.2).

[14] ACCC Draft Decision, *Statement of Principles for the Regulation of Electricity Transmission Revenues – Background Paper,* August 2004

11 Transitional Capital Expenditure Arrangements

We welcome the inclusion of the transition arrangements for capex incurred during the first revenue control period set by the ACCC and believe that this will have a positive impact upon the process of an ex post review. However, the arrangements must address the treatment of capital incurred in the current period and how this will be rolled into the asset base with no loss of returns due to a change in methodology.

We agree with the ACCC's view that *"a simplistic and doctrinaire interpretation of good industry practice that fails to take account of the real world constraints faced by a TNSP is contrary to the spirit and letter of the code".* Furthermore, the ACCC's concept that prudent investment would be *"the amount that would be invested by a prudent TNSP acting efficiently in accordance with good industry practice"* is a sound basis for determining whether historical capital expenditure was indeed prudent.

We believe that the three stages described in the draft decision adds clarity to the process and forms a good basis for an ex-post review. In general, the stages are in line with what we would expect to have to illustrate to prove prudency of our historical capital expenditure.

However, the transitional arrangements fail to acknowledge the arrangements in place allowing a TNSP to receive financial reward for management induced efficiencies in the delivery of the capital projects. We strongly believe that the transitional arrangements should continue to treat capital efficiencies in line with the ACCC's Draft Statement of Principles for the Regulation of Transmission Revenues proposed statement S7.2, whereby:

> *"The TNSP is invited to demonstrate in its regulatory review application that any capital expenditure below forecast levels over the previous regulatory period has arisen because of management induced efficiency gains.*
>
> *Where it is clearly demonstrated by the TNSP that capital expenditure shortfalls are the result of management efficiencies or innovation, the capital expenditure efficiency gains may be subject to a glide path."*[15]

[15] ACCC, *Draft Statement of Principles for the Regulation of Transmission Revenues*, May 1999

This approach is consistent with the requirements that the Code places upon the ACCC, in that the ACCC must administer an incentive based regulatory regime that:

> *"provides an equitable allocation between Transmission Network Users and Transmission Network Owners and/or Transmission Network Service Providers (as appropriate) of efficiency gains reasonably expected by the ACCC to be achievable by the Transmission Network Owners and/or Transmission Network Service Providers (as appropriate)"*[16]

[16] National Electricity Code, clause 6.2.2