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Dear Paul,

**RESPONSE TO ERGON LETTER RE POWERLINK'S SUBMISSION**

Ergon's commentary on Powerlink's submission contains a number of oversights and misunderstandings, and promotes a narrow view which is not necessarily in the best interests of customers.

## 1. Comparative risk of Powerlink's business

The Ergon document contains a material omission. Whilst Ergon declares itself to be an electricity retailer, it failed to mention that Ergon is also an aspiring gas aggregator and marketer, with its ambitions in this regard – which would be a significant expansion to Ergon's business – tied closely to the development of gas pipelines in Queensland.

In its gas role, it is only natural that Ergon would seek to significantly downplay the threats to Powerlink's transmission business of a gas pipeline which ran in parallel with the transmission grid.

The development of such a pipeline would create an energy delivery system (gas pipelines and local generation) which would compete directly with the existing energy delivery system of which Powerlink's long, thin grid is an integral element.

The arguments put forward by Ergon in section 4 of its response (Cost of capital) suffer from both Ergon's inherent bias as a would-be gas marketer and errors of fact.

(a) Contrary to Ergon's assertions, Powerlink's grid can be by-passed by an energy delivery system which comprises a gas pipeline in parallel with the grid and generation close to the major load centres. Powerlink's grid extends 1700kms from Cairns to the Gold Coast. The proposed pipeline with which Ergon is associated as gas aggregator/marketer run over a totally parallel path for almost the entirety of this distance. The proposed pipelines are strongly supported by the Qld Energy policy. Recent newspaper reports confirm the plans for extensive gas pipeline development in Qld by the Australian Pipeline Trust.

This is an "asset stranding" risk for the Qld grid – a risk which is significantly larger than that faced by any other network in Australia.

The threat of this competition is very real to Powerlink, and has been the major driver behind Powerlink's actions to reduce its operating costs over the past three years from 3.8% of asset value (about the average for transmission entities in the region) to 2.4%, the lowest in the region.

(b) A number of the items raised by Ergon are irrelevant e.g. all regulated networks have a predictable income stream underwritten by "overs and unders" arrangements. Powerlink's submission did not seek to identify this as a relative disadvantage, and neither is it a relative advantage to Powerlink as Ergon suggests.

(c) Like all transmission networks, Powerlink is liable for outages resulting from its actions as a TNSP – any protections in the Code are limited to MSO functions, which form a very small part of the activities of a TNSP. MSORC does not change that. Powerlink's relative disadvantage is the combination of a long, thin grid (with minimal inter-meshing) and high loads, which cause the equipment to be operating at or near their limits for extended periods.

In summary, Ergon's assertions are not valid. Powerlink's network is exposed to a higher relative risk, and the equity beta needs to reflect that.

## 2. Impacts on Customers

Ergon has speculated on the impacts of higher transmission revenues for Powerlink on electricity customers, and in doing so, has taken a very narrow view – one which is not necessarily in the interests of customers.

Customers are impacted by two related matters – reliability of supply and the total delivered cost of electricity, not just the transmission component, which in Qld, averages a mere 7% of the total delivered cost.

### 2.1 Reliability

An important element in the growth in Powerlink revenues is the growth in network assets via the capex program. This, in turn, is driven by the high load growths in the State, and the starting point of a heavily loaded grid. A recent NEMMCO report *(Review of Regions)* has shown the Qld grid to be by far the most congested in the National Electricity Market (NEM).

Powerlink's network capex is almost entirely reliability-driven i.e. to meet the reliability standards in the Code.

One of the largest reliability augmentations is the Cairns reinforcement. When Powerlink sought to apply its usual "risk management" approach to this augmentation (i.e. to delay the augmentation as long as possible), both Ergon and its customers (via the customer-representative FNQ Electricity Council) insisted that Powerlink expedite the reinforcement to deliver Cairns the level of reliability appropriate for a major international tourist destination.

Under those circumstances, it is inconsistent for Ergon to be proposing that Powerlink be deprived of the necessary capex allowance or necessary rate of return to be able to meet these legitimate customer requirements.

Ergon queried why Powerlink's O&M costs increase in future years. As Powerlink's submission pointed out, a significant element in its future O&M costs is refurbishment of aged plant. This has become significant because of the age profile of the plant.

Ergon is aware that a failure of such ageing plant in 2000 caused the largest loss of supply event in Qld for the past 10 years. This outage measured nine system minutes, and impacted some of Ergon's major industrial customers. The amount of plant which is reaching the age where it needs refurbishing is increasing, and this is driving much of the increase in O&M costs.

Powerlink is aware from meetings with Ergon and its larger customers that those customers would be very concerned if the planned refurbishment program was impacted by a lack of funding.

We would note that the ACCC's consultants verified the need and the size of the refurbishment program.

## 2.2 Cost Impacts

The Ergon document fails to recognise the beneficial impacts of transmission augmentations on the total delivered cost of electricity to customers.

Apart from reliability benefits, transmission augmentations – especially in a congested long, thin grid like Queensland's – act to reduce key elements of the total cost of electricity to customers.

If the ACCC followed Ergon's suggestions of constraining transmission revenues to discourage these investments, then contestable customers (and even Ergon!) would be financially worse off.

By way of example, an analysis of the QLD–NSW Interconnector (QNI) is enlightening. There was no underlying load increase to absorb the cost of QNI – it results in an increase in TUOS to retailers and customers in NSW and Qld, including Ergon. And, on this basis, Ergon's arguments would have this declared as undesirable. The TUOS increase in NSW and Qld totals around $0.8M per week.

Yet, in reduced ancillary services costs alone, QNI is saving retailers and customers around $2.5M per week - benefits which would not be available if the ACCC followed Ergon's suggestion to constrain transmission revenues and the resultant TUOS. QNI has also delivered higher reliability and lower pool price volatility, and increased generator competition, which will lead to lower energy costs for customers.

Another example is the above-mentioned Cairns augmentation. Whilst that project, and the resultant increase in TUOS, are fully justified on reliability, it also happens to significantly reduce transmission losses, which are a part of the delivered cost to retailers and customers. This project reduces the MLF in Cairns by a huge 11%, which overshadows the small increase in TUOS.

Due to the fact that the existing, long lines in Qld are heavily loaded, planned future augmentations deliver a similar reduction in MLF, even though that is never the primary driver for the augmentation. Indeed, if Powerlink's augmentation program was constrained (e.g. by a

WACC which was too low), the high annual load growth would burden both Ergon and its customers with ongoing increases in MLFs.

More importantly, the coming five years provide Ergon and its customers with both the largest opportunity to access low cost electricity and the largest threat to accessing those low electricity prices. A large amount of low cost generation capacity (Callide C, Millmerran, Tarong Nth) is entering the Qld region, together with competition from NSW generation via QNI. This should – all things being equal – provide Ergon and its customers with access to the lowest cost electricity in years.

But all things aren't equal - NEMMCO's recent report shows that the Qld region suffers the most congested grid in the NEM, and the persistence and growth of network constraints will, in the absence of major augmentations, deny Ergon and its customers access to that low cost electricity. Instead, Ergon and many of its customers would be faced with inordinately high electricity prices, and ever-increasing MLFs.

The worst outcome for Ergon and its customers would be if the ACCC determined too low a WACC for Powerlink. This would result in no augmentations to relieve constraints, and the already congested Qld grid would become even more heavily congested. Those constraints are the only thing standing between customers and lower energy prices over the coming years.

This revenue determination is going to be pivotal for customers – it will determine whether they get access to the low cost electricity or not.

The best outcome for Ergon and its customers is for the ACCC to provide Powerlink with a revenue determination which includes adequate allowance for capex (and the ACCC's consultants have validated Powerlink's estimates), and a WACC which encourages investment in augmentations. That outcome might or might not result in an increase in TUOS, but will also deliver reductions in both energy cost and MLFs.

Unconstrained access to the anticipated low wholesale electricity prices will be good news for electricity customers. (It may not be good news for a would-be gas marketer!)

An outcome, which focuses on constraining TUOS, will deliver higher energy costs and losses which will far outweigh the minor savings in TUOS. As stated above, TUOS is only 7% of the total delivered electricity cost in Qld. A 10% increase in TUOS – if nothing else changed – would only increase total delivered cost by 0.7%. By comparison, an 11% decrease in MLF (as in the Cairns reinforcement)

will reduce total delivered cost for those customers by about 4%. More importantly, the adverse impacts of persistent grid constraints can increase total delivered prices by much larger amounts.

The real potential "price shocks" for Ergon and its customers won't come from TUOS. They will come from being denied access to the much-anticipated low energy prices by network constraints.

Ergon's customers will be best served if the ACCC takes a wider, more rational view of transmission revenues than the narrow view which Ergon has espoused in its document.

## 3. Operating Cost Efficiency

The Ergon document contains numerous errors and inconsistencies in its assertions about operating cost efficiency. Rather than list them all, we have identified two which illustrate the point: -

(a) The ACCC's consultants reported that *"Powerlink's internal labour rates are within 10–15% of the external service provider rates".* Ergon's "analysis" was to interpret this (non-directional) statement as meaning that Powerlink's costs were higher, accompanied by the rhetoric of *"concerns about premiums".*

In fact, the consultants identified Powerlink's costs to be lower.

(b) Ergon seeks to downplay the effects of geography and distance on Powerlink's costs. We would note that in its own revenue submission to the QCA, Ergon argued that geography and distance were a major driver of its network costs.

However, the ACCC's consultants were able to conduct detailed "drill downs" on Powerlink's costs, the cost drivers and assumptions underlying future costs. The consultants validated Powerlink's position as the lowest cost transmission entity (despite the disadvantages of geography) and confirmed the reasonableness of the future cost estimates.

The ACCC should rely on the detailed analysis.

## 4. Conclusion

The risks facing Powerlink's network – particularly from the impending development of gas pipelines in parallel with the grid – are significantly larger than for other networks. It is natural for Ergon, in its role as an aspiring gas marketer, to downplay those risks.

Electricity customers in Qld face reliability risks if the most constrained grid in the NEM is not developed fast enough to meet high load growths, and if ageing plant is not refurbished. Powerlink's submission addresses both issues, and the scrutiny of the ACCC's consultants verifies our approach.

Electricity customers in Qld may well face potential "price shocks", but the threat is not—as Ergon suggests—from increases in TUOS. After all, TUOS is only 7% of the total delivered cost of electricity, and transmission augmentations deliver reductions in other parts of the price chain e.g. MLFs.

The real threat of "price shocks" will come if network constraints are not overcome in a timely manner. That would occur if Powerlink's ability to invest was inhibited by too low a WACC.

The ACCC should take a much wider view of customer impact than the narrow view espoused in the Ergon document. .

In relation to O&M costs, the ACCC should rely on the detailed analysis undertaken by its consultants.

Yours sincerely,

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**CHIEF EXECUTIVE**