Queensland Government

Department of
**Mines and Energy**

Your Ref:
Our Ref: DG/07/02505

Mr Steve Edwell
Chairman
Australian Energy Regulator
PO Box 5250
MELBOURNE VIC 3001

Via email: AERInquiry@aer.gov.au

**RE: POWERLINK REVENUE RESET DRAFT DETERMINATION**

Dear ~~Mr Edwell~~ Steve,

Thank you for the opportunity to comment on the Australian Energy Regulator's (AER's) draft decision regarding the Powerlink Queensland (Powerlink) revenue reset.

High forecast economic growth, and associated high load growth, over the period of the revenue reset will drive the need for record investment in transmission services and the augmentation, maintenance and replacement of transmission assets in Queensland. The Queensland Government remains committed to enabling this necessary investment and I urge the AER to play its part by providing sufficient revenue to enable Powerlink to continue to adequately maintain and augment Queensland's transmission network to meet growing demand.

Detailed comments on the draft revenue determination are attached for your consideration.

Should you wish to discuss this submission further, please contact Mr Alan Millis, Deputy Director-General of the Department of Mines and Energy, on telephone (07) 3224 2191.

Yours sincerely

**DAN HUNT**
**Director General**
**Department of Mines and Energy**

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**ATTACHMENT A**

**Comment from the Department of Mines and Energy on the AER's Draft Decision on Powerlink's Revenue Cap for 2007/08 – 2011/12**

Approach to Regulatory Requirements

The AER's draft decision documents that both the AER and its consultant, Parsons Brinckerhoff Associates (PB), recognised that the rigor of Powerlink's governance and planning policies and procedures provide a framework consistent with efficient investment outcomes.

However, PB's approach does not appear to have had adequate regard to the risks Powerlink manages, repeatedly making statements justifying the exclusion of proposed expenditure for asymmetrical reasons, including that to do so:

- "*would not materially degrade Powerlink's ability to meet its reliability based network obligations or impact on its ability to meet its service standards*"; (p.49); or
- may be done "*without considerably increasing risks*" (p. 71); or
- "*without any material impact on the level of service*" (p. 69).

Reductions on this basis account for some $417 million of the capital expenditure forecast by Powerlink (17 percent of the forecast expenditure), as well as a further $74 million in operational expenditure (9 percent of proposed). The cumulative reduction considerably increases risks for Powerlink. These risks are further exacerbated in a continuing environment of high load growth, where Powerlink must deliver a significant non-discretionary program of capital expenditure, leaving it particularly exposed to steeply rising input costs.

PB's approach has insufficient regard for the fact that Powerlink's transmission licence is contingent upon it meeting legislated reliability standards. This raises significant concerns as to whether the draft decision fully takes account of the gravity of Powerlink's responsibilities and awards it sufficient revenue to meet these. Such concerns are most acute regarding the allowance awarded for capital expenditure (capex).

Reasonableness of Capex

The AEMC's Draft Determination on Rules for the Economic Regulation of Transmission Services recognises that: *"TNSPs, like most businesses, operate in an uncertain environment. Uncontrollable, external events as diverse as changes in economic growth, climate and regulatory obligations can alter the quantity and nature of the services required to be provided by TNSPs…if TNSPs are required to respond to market demand by altering their production behaviour and this requires unexpected investment in new network capacity, the arrangements need to provide for this"* (p. 78). These comments are particularly pertinent in light of revision necessary for Powerlink's current regulatory period.

The AER's draft decision accepts the prudency of Powerlink's actual capex in the current regulatory period. Above-forecast demand growth and input costs in the latter years necessitated capex some $219 million (or 21 percent) above the allowance awarded for the period, despite the best efforts of both Powerlink and the Australian Competition and Consumer Commission (ACCC) to determine the appropriate expenditure for the period. The extent of this miscalculation reflects the scale of the risks managed by Powerlink in the prevailing environment – and the importance of the AER making a careful assessment of the need for forecast expenditure, with due consideration for the risks of failing to do so. It also highlights the need for effective mechanisms to adjust revenue in-period as required.

In its draft decision on capex, the AER stated that: *"The AER's overall assessment is that Powerlink's probabilistic planning approach provides a robust method to determine its load driven capex requirements, particularly given the high forecast levels of demand growth and the uncertainty surrounding generation developments in Queensland"* (p. 56). The AER also acknowledged the reasonableness of Powerlink's capex proposal: "*the probabilistic weighted average capex sought by Powerlink is slightly less than what would result from the average of the medium growth scenarios*" (p. 59). These comments appear inconsistent with the 17 percent reduction in capex allowance provided for in the draft decision. Key components of this reduction are examined in more detail below.

Capex for Load Driven Upgrades

PB's report stated: "*Powerlink had undertaken a systematic and rigorous review of a complex network using advanced planning techniques*" (p. 66). Yet PB recommended that Powerlink be awarded an allowance some $147 million less than sought for load driven upgrades, due to the potential for optimising the scope and/or timing of ten projects, with timing adjustments based on median timing. This ignores the fact that TNSPs have little discretion on the timing of load-driven upgrades, which is dictated by mandated reliability standards.

Recognising that a significant degree of judgement was necessary in evaluating this component of Powerlink's proposal, the AER employed a second consultant to review PB's findings. In general, the AER accepted all adjustments where both consultants agreed, removing $127 million from the revenue Powerlink requested for load driven capex. Where the two consultants disagreed, the AER has sought further information from Powerlink. Noting the rapid, above-forecast load growth that Powerlink has had to accommodate in the current regulatory period, and that Powerlink's proposal seeks less than the average of the medium growth scenarios, the relatively subjective assessment of this component of Powerlink's proposal appears injudicious.

Given the extent of the capex program required in the upcoming regulatory period, Powerlink has identified key opportunities to achieve long-term efficiencies by incorporating design elements in some of these projects now to greatly reduce the cost of later augmentations when these become necessary. This is consistent with the National Electricity Market (NEM) objective, which focuses on achieving efficient long-term outcomes for customers. In this context, it appears inappropriate to consider only the lowest initial cost outcome within a five year regulatory period. With the average life of transmission assets around 40 years, this is a very short-term

view that would result in customers paying significantly more for subsequent upgrades when they are required.

It is also noted that, in "optimising" the scope of some projects, PB has ignored key principles of good electricity industry practice, such as prudent avoidance. Whilst some of these principles are not currently required by law, they are followed by all responsible operators to minimise the potential of exposure to future changes to, or broader interpretations of, legal requirements. In this way, the practices also meet the NEM Objective, in safeguarding the long-term interests of customers.

Capex for Replacement Assets

PB recognised the need for replacement of all projects reviewed. Yet, whilst PB considered the scope of some of Powerlink's replacement projects greater than justified, it was unable to form a view on the amount by which replacement expenditures should be reduced. This raises some concerns about the rigor of the consultant's assessment and its understanding of the cost of transmission assets in the current Queensland environment. Instead, the consultant adopted a minimalist top-down approach, adopting a number of questionable assumptions - with no consideration for need - that reduced Powerlink's allowance for replacement by $111 million. The AER accepted this recommendation.

This approach appears inconsistent with a statement by the AER in its draft decision, which states: "*a definitive view on the efficiency of the overall capex program can only be obtained by examining the need, timing, scope and cost estimates of the projects that make up the overall weighted average capex program*." (p. 55). Particularly given the extent of the reduction, a more thorough analysis may be appropriate.

Cost Accumulation Process for Capex

Acute volatility of input costs has led Powerlink to provide revised estimates of input costs within just eight months of providing its original proposal, with copper prices alone doubling in this time. Such volatility suggests that a more flexible approach to input costs (especially for base planning objects – the unit rates applied for asset types) may be prudent.

In particular, it appears incongruous for the AER to accept the prudency of wage escalation rates in Powerlink's current EBA to achieve wage parity with TNSPs in the southern states, yet refuse to allow Powerlink to maintain wage parity with southern TNSPs, as set in their EBAs. This decision also impacts upon the opex awarded.

Contingent Projects

With the timing of Powerlink's revenue reset coinciding with the Rule making process for the Economic Regulation of TNSPs, it was agreed that the AER would assess Powerlink's current revenue proposal under the Chapter 6 Rules in force at the time the proposal was prepared, whilst substantially adhering to the existing ACCC Statement of Regulatory Principles (SRP). Some minor modifications were agreed by the two parties to smooth the transition to the new regime.

However, the AER has retrospectively applied the threshold and parameters for contingent projects contained within the Final Rule, as published on 16 November

2006, to its assessment of Powerlink's Revenue Proposal, which was submitted on 3 April 2006. Changing the parameters under which the proposal is to be assessed after it has already been submitted does not allow Powerlink to adjust its risk profile accordingly.

Revenue totalling $52 million for contingent projects proposed by Powerlink was disallowed due to the AER's decision to apply the materiality threshold in the new Chapter 6A Rules. This threshold was applied despite a provision in the SRP enabling TNSPs to apply for any specific projects to be included in the contingent projects provision, "*even where this value threshold is not satisfied*," with the recognition of such projects at the regulator's discretion. In contrast, the draft decision does not apply a materiality threshold for undergrounding projects, attributing this to the uncertainty of the undergrounding projects and their relatively high cost compared with alternatives. Such uncertainty could equally be applied to several other contingent projects proposed by Powerlink, with the cumulative risk of these significant.

PB considered that excluding certain proposed contingent projects would "*not materially increase the risks faced by Powerlink*" (p. 85). This argument presents an asymmetrical view of regulation. Recognising any project as a contingent project imposes no risk on the regulator as the project must be deemed both necessary and the most cost-effective solution to address the trigger to pass the AER's Regulatory Test. However, failing to recognise contingent projects may expose a TNSP to necessary, but unfunded expenditure.

It also appears that the AER may have applied a more exacting interpretation of the probability of a trigger event occurring during the period than the Rules suggest was intended, and certainly a higher barrier than indicated in the SRP. The Rules were intended to cater for uncertain – not committed – projects. This is exacerbated by the AER's retrospective application of the highly specific definition of triggers required in the Final Rule, which precludes the contingent projects provision from accommodating projects that may become necessary due to a range of different triggers.

Given the short lead time generally allowed for some major infrastructure projects, this risk may be significant, particularly for Powerlink, which is operating in an environment of high load growth and significant industrial and mining development. In its Supplementary Proposal, Powerlink has sought the inclusion of additional contingent projects. This includes any desalination plants triggered in-period and $60 to $200 million for the augmentation of supply to South East Queensland, to provide flexibility to manage transmission requirements, should this be required.

Particularly given the volatile, high load growth environment within which Powerlink currently operates, the cumulative risk Powerlink bears regarding uncertain projects is potentially great. In the prevailing Queensland environment, and given the limited discretion of TNSPs in responding to load growth, it seems prudent to accommodate contingent projects that may be considered speculative, provided an appropriate trigger can be identified.

Shift in Capex Accounting Methodology for Work In Progress

The AER's preference for recognising capex in the regulated asset base as it is incurred may strengthen efficiency incentives, yet it advances costs to customers without delivering any benefits to them. Given the scale of Powerlink's work in progress, applying this approach to this revenue reset would result in a one-off increase in Powerlink's regulatory asset base of over $500 million.

It appears that the AER may be restricting the capex allowances it awards to Powerlink to compensate for significant price rises necessary to accommodate the AER's adherence to a partially "as incurred" approach. If so, this would frustrate the incentives intended to reward TNSPs for efficiently managing the prudent reliability and security of supply.

It is appropriate that the AER maintain downward pressure on prices. However, these provisions must recognise that customers regard reliable electricity supply as an essential service. Supply shortfalls are not acceptable solely in the interests of maintaining the lowest cost service. The foremost obligation of the regulator is to enable TNSPs to recover the efficient costs of work necessary to maintain reliability and security of supply. These aims must not be compromised to satisfy pricing pressures caused partly by an accounting preference.