QUEENSLAND
MINING COUNCIL

15 May, 2001

Mr Michael Rawstron
General Manager - Electricity Regulation
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Dear Mr Rawstron

Review of Powerlink Queensland's transmission revenue

Our council would like to comment briefly of some aspects of Powerlink Queensland's (PQ) transmission revenue application. I hope the lateness of this submission does not prevent you from taking account of our views.

Cost of capital
There are two elements of PQ's application on cost of capital that are of particular concern to the mining council, as follows.

<u>Treatment of taxation</u>
PQ argues for a pre-tax (real) approach to derivation of the WACC, but nevertheless states its calculations in post-tax (nominal) terms in line with the commission's draft statement of principles for transmission revenue regulation.

Regulated entities prefer the pre-tax approach because the difficulties associated with estimating a long run effective tax rate means that regulators invariably assume the statutory company rate. This enables the entity to retain the benefits of such tax concessions as accelerated depreciation, which can be significant in the case of capital intensive activities such as electricity transmission.

However, contrary to PQ's assertion, it is not appropriate that the TNSPs be allowed to retain such concessions. The aim of regulation is to emulate competitive outcomes, and in a competitive situation tax concessions will be passed on to consumers. While PQ is correct in saying the aim of the concessions is to promote productive investment, they are meant to do this by making capital investment <u>generally</u> more attractive in relation to other uses of funds.

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The concessions are not meant to advantage a particular activity over another, or regulated monopolies over unregulated competitive businesses, which would be the effect if TNSPs were allowed to retain the tax concessions as PQ suggests.

<u>The commission should disregard PQ's arguments for a pre-tax approach and derive a post-tax nominal WACC in accordance with the draft principles and its determination of TransGrid revenue.</u>

<u>Asymmetric risk premium</u>

PQ argues for a 1.3% premium in the cost of equity in recognition of what it claims is its significant risk of asset stranding/re-optimisation. PQ says it faces materially higher risks than other electricity transmission entities because of higher loading and greater uncertainty about future load growth, uncertain future generation patterns, the effect of the new state energy policy, and greater impact of the federal 2% renewables energy policy in Queensland.

Our council does not believe PQ's argument is supportable, for a number of reasons. First, specific risk factors such as those mentioned by PQ should not figure in the cost of capital calculation. The commission's benchmarking approach to deriving the asset beta is meant to abstract from such risks which, even if they need to be compensated for, should not be built into the rate of return that will apply whether or not the risks are actually realised.

Second, the WACC derived from benchmarking against comparable entity's will already accommodate a degree of asset stranding risk implicit in the nature of the business. Regulatory re-optimisation is meant to replicate the effects of a competitive market in rewarding technological improvement and penalising poor investment decisions, and a regulated entity's allowable revenue should not be inflated to protect it from re-optimisation.

Third, PQ does not adequately demonstrate that its level of asymmetric risk is materially higher than that of other TNSPs. The application does not provide evidence of this in regard to future load patterns or the impact of the 2% renewables policy. And it could be argued that the Queensland energy policy has reduced rather than exacerbated uncertainty about the depth and timing of future competition from gas. The policy says that no more coal-based generating licenses will be granted in Queensland unless it is absolutely necessary, and that by 2005 at least 13% of the electricity sold in the state must be sourced from gas generation. It presents a more predictable picture of the deferral of prospective coal-fired power stations (the Kogan Creek power station proposal has already been shelved) and the bringing forward of gas projects and, presumably, of the resulting effects on transmission loadings.

Finally, PQ's claim that the ACCC's flexible approach to depreciation cannot accommodate it's stranding risk (because its by-pass risks will arise too quickly for PQ to satisfy the commission's requirement for advance notice) is not credible. Our council can see no reason why PQ, like other regulated transmission entities, cannot either avail itself of the opportunity to argue for the accelerated depreciation of assets at risk of standing or, as the commission says in its draft regulatory principles, chose to 'enjoy the fruits of the regulatory rate of return on assets at risk against the capital loss associated with by-pass'.

The commission has established the appropriate approach to asymmetric risks like asset stranding risk in its draft principles and TransGrid revenue determination. This approach should be applied to PQ, as follows:

- First, for the commission to determine that PQ was subject to a material overall negative asymmetric risk it would need, having weighed up all the applicable risks, to be satisfied the effect of the negative risks outweighs that of the positive risks.
  - Our council questions whether PQ has demonstrated a material, net negative asymmetric risk. Predictably, PQ's application highlights the negative (eg. new coal and gas projects may reduce regional interconnector loadings, resulting in their re-optimisation) but does not countenance offsetting beneficial effects (might not lower interconnector loadings reduce the costs of maintenance of those lines and the costs of network voltage control generally?).
  - Further, the paper "Estimation of Additional Asset risks Associated with New Queensland Gas Transmission Projects" appended to the application does not, contrary to PQ's assertion, demonstrate that a 1.3% premium would be a conservative allowance for its asymmetric risk. The paper's logic is purely circular; it does not explain how the basic premise of 20-40% optimisation risk is arrived at, or the link between that claim and the proposed 1.3% premium.
  - Finally, we understand Powerlink has arrangements in place with the Queensland distributors that significantly mitigate its asset stranding risks. The arrangement works through asset stranding provisions of connection agreements, which we understand are consistent across all first and second tranche contestable customers in Queensland. The relevant 'Schedule 5 Calculation of the Costs of the Stranded Assets' entitles the distributor and Powerlink to recover amounts from customers that fail/cease to take supply from reserved or contracted capacity that becomes unutilised/stranded as a result. The recoverable amount can be as much as 435% of the fixed and demand portions of their annual distribution and transmission costs, depending on the amount of notice given by the customer.
- Second, any material net negative asymmetric risk would not be incorporated in the WACC as a premium or inflated beta but, depending on the nature of the risk, would be dealt with in the calculation of the initial regulatory asset base, forecast capital expenditure and in the depreciation profile or other elements of expected cash flow.
  - In regard to potential asset stranding, PQ should be required to make the case for any compensation measure, like the accelerated deprecation of an asset, and any written down assets should be carried forward at current values and reinstated to the regulatory asset base in the event that they remain in service and adequately utilised.

The mining council believes PQ is arguing for the 1.3% premium to achieve equivalence with the ACCC's determination of TransGrid's cost of capital, but in a lower interest rate environment than that prevailing at the start of TransGrid's regulatory period. (This desire to negate the decline in interest rates over the last 12 months is evident also in PQ's application for a debt margin of 167 basis points, rather than the 100pb margin applied to Transgrid, yielding a debt cost of 7.7% compared to TransGrid's 7.8%).

<u>We believe the commission should reject the request and apply its established principles, and the precedent approach in its TransGrid determination, in deriving PQ's allowable rate of return.</u>

Operating costs

Our council is concerned that PQ is not offering any future operating cost efficiency savings for incorporation in its allowable revenue cap.

The application says that PQ has already put in place available improvements in corporate and maintenance practices, and cites PQ's ranking in the best performance quadrant of the 98/99 ICTP benchmarking study and the maintenance element of the 99 ITOMS study. Indeed, PQ says its placing in the 'below average cost/reliability quadrant' of the ITOMS study in respect of substation maintenance indicates that it needs to spend more on the operational refurbishment of aging plant, and has included such expenditure in its opex projections.

We believe the commission needs to:

- satisfy itself as to the relevance of the ICTP and ITOMS analyses to its consideration of PQ's current and future opex efficiency; and

- assess the appropriateness of PQ's plans to include plant refurbishment costs in opex to ensure there is no double counting of operating and capital costs.

In this regard, we note the findings of the PB Associates review of PQ's opex projections, including that 'further opportunities [for more efficient/effective practices] could include achieving greater maintenance synergies for new assets so that overall maintenance costs increase at a rate slower than that assumed, and treating as capital project related dismantling work, which is currently included in operating expenditure'.

Thank you for the opportunity to comment on PQ's application, and for the guidance the commission has provided in its draft revenue regulation principles and precedent determinations. We look forward to the commission's draft determination.

Yours sincerely

Ben Klaassen
Economist