INTRODUCTION

The purpose of this submission by Queensland Treasury is to respond to the Draft Determination "Queensland Transmission – network revenue cap 2002-2006/07" (the Draft Determination) issued by the Australian Competition and Consumer Commission ("ACCC") in July 2001.

In making this submission, Queensland Treasury notes that it has a broad range of roles including that of shareholder, promoter of economic development via balanced regulatory frameworks and surrogate purchaser of transmission services as a result of partial tariff subsidisation in Queensland.

In relation to these roles, Queensland Treasury notes that it has charged the Board of Powerlink Queensland (Powerlink) with primary responsibility for protecting the Government's shareholder interests. Accordingly, Queensland Treasury does not comment on issues related to the Government's shareholder interests in relation to economic regulation decisions except where these interests correspond with broader economic regulation objectives, such as the need to maintain appropriate investment incentives for regulated entities.

In this submission, Queensland Treasury seeks to ensure that the ACCC's final decision represents the most efficient form of regulation for Powerlink. Specific comments will relate to the need for regulatory certainty, through consistency with previous TNSP regulatory decisions, and on the impacts of revenue smoothing.

In making these comments, Queensland Treasury has balanced its views in line with its broad role of promoting economic development in Queensland and with its role as a surrogate purchaser of electricity as a result of subsidised franchise tariffs that exist in parts of Queensland.

Queensland Treasury notes that, in making its Final Determination, the ACCC must balance the interests of consumers against the future electricity infrastructure needs of Queensland to ensure that the impact of regulated pricing creates no disincentive to invest in essential infrastructure. This will ensure that the supply side competition benefits that can flow from investment in transmission network infrastructure are not impeded by less than viable returns on those investments. To a large degree, Queensland Treasury is of the view that the ACCC has adequately achieved this balance in the draft determination.

ACCC'S REGULATORY APPROACH

Queensland Treasury notes that the ACCC has adopted a revenue cap approach which is substantially consistent with the Code and the ACCC's draft Statement of Regulatory Principles.

However, Queensland Treasury has concerns with aspects of the ACCC's draft determination which relate to inconsistencies in the treatment of Powerlink vis-à-vis other TNSPs revenue cap determinations and with the Code. Queensland Treasury is concerned to ensure a consistent approach to economic regulation of TNSPs which reduces potential regulatory risk and creates appropriate incentives for transmission infrastructure investment.

A regulatory risk exists to the extent that changes may be made to a final ACCC Statement of Regulatory Principles. Queensland Treasury understands that the ACCC is looking to finalise this Statement in a staged process, with further consultation to occur with TNSPs, market participants and jurisdictions. Queensland Treasury would like to use this process to raise key issues in relation to the regulatory framework.

In particular, Queensland Treasury would like to discuss key aspects of the current regulatory framework that relates to the cost of debt management, and to incentives to invest in regulated markets. Whilst these issues affect Powerlink, this submission is not the most appropriate forum in which to raise fundamental regulatory issues. At this stage Queensland Treasury wishes to highlight the existence of key regulatory concerns, and the willingness to discuss these concerns with the ACCC.

Queensland Treasury sets out its comments below (in the order they appear in the draft determination).

THE COST OF CAPITAL

Risk Free Rate

In the draft determination, the ACCC has proposed the use of the 5½ year rate determined by the 40 day moving average of the 5-year and 10-year Commonwealth bond yields (as averaged to provide for a 5½ rate).

The ACCC has argued that the 5-year yield rate provides an appropriate measure of the risk free rate because the asset owner's inflation risk (for the regulatory period) is appropriately compensated by the implicit inflation risk premium incorporated into the yield. On this basis, the ACCC indicates that the risk of actual inflation diverging from anticipated inflation is limited to the five-year period.

As Queensland Treasury understands the draft determination, to compensate Powerlink for this divergence from past practice, the ACCC has provided a higher debt margin vis-à-vis that applied to other TNSPs in past regulatory decisions (refer part 2.5). Queensland Treasury would make three observations about the proposed change:

(1) The proposal to utilise a shorter-term instrument fails to recognise the underlying asset structure of the TNSP, which is inherently long term, and therefore inconsistent with the investment horizon of the business. The inflation risk on these assets is not confined to the regulatory period but to the investment life of the asset;

(2) Utilising a higher debt margin to offset the change in the term of the risk free rate does not have an equivalent and opposite impact on Powerlink's WACC to compensate for the use of a shorter term debt instrument as the risk free rate; and

(3) This approach is inconsistent with the ACCC's determination in relation to Transgrid's revenue cap (where a 10-year Commonwealth bond yield was used).

Queensland Treasury notes that the Queensland Treasury Corporation has also lodged its own submission which provides further analysis of the use of a 40-day moving average and the use of a shorter-term Commonwealth bond yield as a surrogate for the risk free rate.

Queensland Treasury recommends that in the absence of strong arguments to the contrary the ACCC adopt the 10-year Commonwealth bond yield as the risk free rate.

OPENING ASSET BASE

Interpretation of Code requirements

The ability of the ACCC to reassess the opening asset values of TNSPs upon transition from the previous State based regulatory arrangements has been questioned by the ACCC. On 18 June 2001, the ACCC wrote to Queensland Treasury seeking our views on their ability to exercise regulatory discretion in relation to this issue.

Queensland Treasury has not sought legal opinion on the ACCC and/or Powerlink's interpretation of the Code but our reading of the Code is that the ACCC is only required to have regard to opening asset values set by the jurisdictional regulator. However, in line with other components of Queensland Treasury's submission, we would agree that the ACCC must maintain consistency with other TNSP regulatory determinations in relation to opening asset values. Queensland Treasury's only concern in relation to opening asset values is the apparent anomaly in the valuation of easements (which are a combination of historical and part revaluations) and the ACCC's preferred approach to value easements at their ODRC. It is understood that the ACCC intends to allow Transgrid the opportunity to transition to such a valuation approach. This methodology is not without issue and the ACCC needs to robustly assess the appropriate method of easement valuation as part of the final statement of regulatory principles and then allow all TNSPs to transition to that regime.

Queensland Treasury recognises that asset valuation issues, including the valuation of easements, have implications for regulated businesses in a number of jurisdictions. The opportunity to discuss changes to asset valuation methodologies with the ACCC would be welcomed by Queensland Treasury.

CAPITAL EXPENDITURE

Approach to capital expenditure

Queensland Treasury notes that the ACCC has accepted Powerlink's proposed probabilistic approach to forecasting capital expenditure and that the ACCC intends to utilise an under and overs process at the regulatory reset to adjust forecasts to actual expenditure.

Queensland Treasury notes that the planning of network augmentation in Queensland is highly uncertain given the impacts committed generation and potential generation projects will have on flows across the network and the potential for other non-network solutions to present themselves within the regulatory period (eg. embedded generation, demand side management etc.). A conservative approach to providing for capex (with an appropriate regulatory reset adjustment) is, therefore, appropriate.

The delivery of timely transmission network infrastructure is essential for ensuring adequate supply side competition in the wholesale electricity market and for providing adequate reliability of supply. Whilst the implications of this requirement are more far reaching than providing for adequate capital expenditure (eg. it also cuts to the operation of the regulatory test for network augmentation), Queensland Treasury is supportive of the ACCC and Powerlink's approach to providing for forecast capital expenditure.

Recognition of QNI management savings

The ACCC has, consistent with an incentive based regulatory regime, recognised in Powerlink Queensland's asset base management induced savings that have accrued in the Powerlink component of the Queensland-New South Wales interconnect. Queensland Treasury agrees that the recognition of actual management induced capital expenditure savings, via short-term revenue reward, is appropriate in an incentive-based regulation regime and strongly supports the ACCC's findings in this regard.

In providing that support, Queensland Treasury recognises that such an arrangement could be interpreted as providing inappropriate incentives of TNSPs. For instance, it could promote incentives to overstate possible capital expenditure to materialise non-legitimate management induced efficiency gains or it could result in TNSPs deferring capital expenditure to the commencement of a regulatory period to maximise the period over which management induced efficiencies are recognised. However, Queensland Treasury notes that these investments follow a robust process to ensure that the level of network investment is efficient, from a cost perspective vis-à-vis other investment alternatives, at the time of project commitment (due to the Regulatory Test). Appropriately, the TNSP carries the risk that any excess investment will be optimised out of the asset base and it is, therefore, appropriate that they be rewarded for any savings they generate. Such a reward recognises that customers have received the lowest cost option (via the Regulatory Test).

Queensland Treasury notes that the ACCC intends to claw back management efficiencies if the non-legitimate efficiencies materialise in out years.

Queensland Treasury supports the recognition of the QNI management efficiencies in the Powerlink revenue base.

OPERATING AND MAINTENANCE EXPENDITURE

Queensland Treasury notes that the ACCC's consultant has substantially agreed with Powerlink's assessment of operating and maintenance expenditure concluding that Powerlink is relatively efficient by Australian and International standards notwithstanding that geographic impediments to achieving this outcome.

Queensland Treasury notes that Powerlink has raised a number of issues in support of real increases in operating and maintenance expenditure. These include:

- pressures to move network maintenance to times of low demand to reduce the impacts on wholesale pool prices (such as proposed in NECA's RIEMNS proposals to provide further access across interconnects);

- increased network augmentation costs associated with Regulatory Test and public consultation processes;

- rising insurance costs and uncertainty of the level of those costs flowing from the MSOIAC2 proposals to revise existing MSO liability arrangements;

- increasing costs associated with grid support contracts in line of network augmentation (in which case, those grid support contracts have been proven, via the Regulatory Test for network augmentation, to be the most cost effective solution).

Queensland Treasury notes that the ACCC has substantially supported the operating expenditure proposals by Powerlink. Queensland Treasury is broadly supportive of the ACCC's conclusions.

Queensland Treasury notes, however, that the ACCC has agreed to reassess on an annual basis, the difference between allowed and actual the grid support contract component of Powerlink's operating expenditure budget. Generally, this would not be consistent with a light handed and non-invasive approach to regulation that is contemplated by the Code. However, Queensland Treasury recognises that recognition of grid support contracts is relatively new, relatively minor to the overall revenue position of Powerlink and potentially highly volatile, due to the dynamics of those contracts and the difficulty in predicting transmission congestion. Recognising these issues, Queensland Treasury agrees with Powerlink and the ACCC's proposals to undertake an annual unders and overs process for network support contracts.

Queensland Treasury supports the ACCC's conclusions on operating and maintenance expenditure.

TOTAL REVENUE

Revenue smoothing

Powerlink has requested and the ACCC accepted, that the transition to the higher revenue cap not occur on 1 January 2002 (the commencement of the regulatory period) but rather deferred to 1 July 2002. Queensland Treasury supports this approach and the reasons behind Powerlink and ACCC's proposals to defer the transition.

The ACCC has provided what it regards as an efficient maximum allowable revenue cap for Powerlink but has adjusted this downwards to protect customers from price shocks. In smoothing Powerlink's revenue, the ACCC has ensured that the impact of this arrangement, from Powerlink's perspective, is NPV neutral. Queensland Treasury supports this aspect of the ACCC's approach to revenue smoothing. Such an approach recognises revenue smoothing which does not provide for an efficient return on investment may have a potential detrimental effect on service standards and a potential negative effect on long-term investment in network assets.

On that basis, Queensland Treasury understands that the ACCC's prime motivator undertaking revenue smoothing is to remove price shocks to consumers. In that regard, Queensland Treasury understands that the major driver of any price shock to consumers under the ACCC determination is not as a result of the transition to a new regulatory period but due to impact of the Queensland New South Wales Interconnect (QNI) asset. It is understood that removing the impact of the QNI assets from Powerlink's revenue cap highlights that, in real terms, transmission prices are actually falling (consistent with a CPI-X regime).

It is a general principle that efficient capital expenditure will be rolled into the asset base as they begin to deliver services. With that in mind, any decision to smooth the revenue impact associated with the QNI asset, by arguably delaying the full recognition of the asset value, is inconsistent with the treatment of other capital expenditures in the asset base.

Irrespective of this inconsistency of asset recognition, Queensland Treasury notes that transmission costs in Queensland for contestable customers generally range from 10% to 20% of the delivered price of electricity. The price shocks associated with the recognition of the QNI asset should be considered in the context of the:

- total impact on delivered electricity prices; and
- beneficial pool price and reductions in other electricity costs (eg. ancillary service charges) which are being realised in Queensland as a result of the QNI asset – based on evidence of the QNI benefits to date.

Based on Queensland Treasury's understanding, the price shocks associated with earlier recognition of the QNI transmission assets are less significant than changes in other components of delivered electricity prices. That is, the earlier recognition of the QNI asset would not significantly disadvantage customers in terms of their overall delivered electricity price.

On this basis, notwithstanding that the ACCC has ensured that Powerlink Queensland is neutral to the value impacts of revenue smoothing , Queensland Treasury is of the view that it would be more appropriate to adopt an approach to revenue smoothing which provided earlier recognition of the QNI assets in line with regulatory practice of recognising capital expenditure and when customers are receiving the benefits of the QNI assets.

From Queensland Treasury's perspective, it is recognised that maintaining this position may have budgetary implications in terms of increased transmission costs associated with our role as a surrogate consumer of electricity (via our subsidisation of certain franchise tariffs), however, we would support an approach to revenue smoothing based on recognition of the QNI asset. This is because the Queensland Government's ongoing subsidisation of franchise tariffs would protect domestic (and other franchise customers) from price shocks.

Queensland Treasury supports the use of an NPV neutral approach to revenue smoothing.

Queensland Treasury recommends that the ACCC adopt a revenue smoothing path that results in a greater price increase in early years when compared to the glide path currently proposed. Queensland Treasury would be prepared to assist the ACCC determine that guide path.

SERVICE STANDARDS

Queensland Treasury is aware that the ACCC is currently developing an approach that will allow revenue related rewards and sanctions to be incorporated into the economic regulation model and be linked to the performance of a TNSP against agreed service standards. Such a system is supported where those rewards and sanctions are linked to standards which are able to be controlled by the TNSP or where the TNSP is adequately remunerated for providing that level of service. However, it is appropriate that the regulatory model and the revenue cap approach provide adequate flexibility and incentive for TNSPs to negotiate service standards and transmission pricing based on commercial terms (be that for greater or lesser standards of service).

In developing this framework, it is understood that the ACCC intends to consult firstly with TNSPs on proposed service standard prior to broader consultation with market participants, jurisdictions and interested parties. Queensland Treasury looks forward to the opportunity to provide feedback on the proposed ACCC's service standards, the link to the economic regulation model and any associated impacts the proposals may have on transmission in the NEM.

SUMMARY OF RECOMMENDATIONS

- Queensland Treasury recommends that in the absence of strong arguments to the contrary the ACCC adopt the 10-year Commonwealth bond yield as the risk free rate.
- Queensland Treasury supports the recognition of the QNI management efficiencies in the Powerlink revenue base.
- Queensland Treasury supports the ACCC's conclusions on operating and maintenance expenditure.
- Queensland Treasury supports the use of an NPV neutral approach to revenue smoothing.
- Queensland Treasury recommends that the ACCC adopt a revenue smoothing path that results in a greater price increase in early years when compared to the glide path currently proposed. Queensland Treasury would be prepared to assist the ACCC determine that guide path.