Your Ref:
Our Ref: DG/06/0895

Dr John Tamblyn
Chairman
Australian Energy Market Commission
Via email: panel@aemc.gov.au

Dear Dr Tamblyn

**RE: DRAFT RULE DETERMINATION:
(ECONOMIC REGULATION OF TRANSMISSION SERVICES) RULE 2006**

I refer to the above Draft Rule Determination and Second Draft Rule regarding the economic regulation of Transmission Network Service Providers (TNSPs) published on 26 July 2006.

I am pleased to note that the proposed Rule generally improves investment certainty for transmission entities by adoption of many components of the existing Statement of Regulatory Principles into the Rule and by specifying a process and parameters for calculating the cost of capital.

Queensland is experiencing a period of sustained economic growth, and associated high load growth, which is driving the need for record levels of investment in transmission network augmentations. In this high growth environment, it is essential that the Rules enable Powerlink Queensland (Powerlink) to raise sufficient revenue to provide for necessary capital expenditure on the timely upgrade and augmentation of the Queensland transmission network to continue to meet mandated reliability standards. In particular, the Department of Mines and Energy (DME) is concerned that the Rule allow for the timely recovery of costs associated with both emergent and contingent development, so that Powerlink can undertake necessary work without unwarranted regulatory uncertainty and delays.

For example, Powerlink is currently negotiating with the Australian Energy Regulator (AER) regarding inclusion of costs associated with a proposed salt water desalination plant on the Gold Coast as a contingent project in its 2007-2012 revenue reset application. The Queensland Government has committed to this plant which has activated this trigger already. It is Queensland's view that the final Rules must provide regulatory certainty that costs associated with such projects are recoverable by Powerlink in the event that projects proceed.

Powerlink must have sufficient regulatory certainty to undertake the operational expenditure required to continue to meet mandated reliability standards in the current Queensland environment of rapid load growth. Of particular concern are proposed Rule provisions for carry over of negative residuals for operational expenditure. This proposal represents far too strong a disincentive for operational expenditure, such as repairs and maintenance, particularly given rapid increases and uncertainty in input costs. This presents a real risk of under-investment for Queensland, where rapid demand growth exposes Powerlink to unforeseen cost increases.

Finally, Queensland recognises the significance of the guidance to assist the AER to determine whether TNSPs' capital and operational expenditure estimates are reasonable. Queensland considers that any assessment of the reasonableness of expenditure estimates must be underpinned by the notion of good electricity industry practice, as defined in the Rules. Setting this as the standard against which all criteria for expenditure estimates are assessed would reinforce the relevance of these standards and promote adoption of good electricity industry practice by all TNSPs.

Further comment on the proposed Rule is attached. I trust this information will be of assistance in further development of the Rule. Should you wish to discuss this matter, please contact Mr Denis Warburton, Director – Electricity and Gas Markets, on telephone (07) 3239 6908, or via denis.warburton@energy.qld.gov.au.

Yours sincerely

SCOTT FLAVELL
Director General
Department of Mines and Energy

Enc.

Department of Mines & Energy
PO Box 15216
City East
Queensland 4002 Australia
Telephone +61 7 3898 0375
Facsimile +61 7 3238 3088
Website www.energy.qld.gov.au
ABN: 98629495885

Attachment 1

Department of Mines and Energy Comment on the Draft Rule Determination (Economic Regulation of Transmission Services)

Reasonableness of Expenditure Forecasts

The codification of the Australian Energy Market Commission's (AEMC's) intended approach to assessing the reasonableness of expenditure estimates is key to the effectiveness of the propose-respond model adopted. The application of these criteria for promoting the desired outcomes could be substantially elevated through couching these criteria within the framework of good electricity industry practice, as defined in the Rules. The notion of good electricity industry practice provides a useful standard against which the criteria for expenditure forecasts of Transmission Network Service Providers (TNSPs) may be assessed, with due regard for all aspects of the TNSPs obligations.

The Department of Mines and Energy (DME) is also concerned about the applicability of benchmarking TNSPs' forecasts against those of an efficient TNSP. With the limited number of TNSPs operating in the National Electricity Market (NEM) – and each reflecting different characteristics, it seems unlikely that much may be gained from benchmarking against any one of these. Such an activity has limited application for Queensland in particular, which is characterised by: a long radial transmission network; significant remote generation; and the highest load factor and fastest load growth in the NEM. All of these features fundamentally impact the scale and direction of TNSP expenditure. DME recommends the adoption of good electricity industry practice as a relevant standard against which to assess all TNSP expenditure estimates.

Revenue Cap Reopening

The Draft Rule states the Revenue Cap Reopener provision may only be triggered by an individual project with a total cost in excess of five percent of the Regulated Asset Base (RAB) at the beginning of a regulatory period. This contrasts with the Draft Determination, which adopts RAB in the year of the event as the benchmark. Therefore, it is not clear what the correct position is to be in the Final Rule.

The Department considers a threshold of five percent of RAB is too high. The Department considers the ability of this provision to assist TNSPs in managing unforeseen risks would be greatly enhanced by applying the threshold to the aggregate of projects required to address a particular extraneous event, rather than a single project alone.

Contingent Projects

The contingent projects provision is intended to manage the risk of significant, foreseen projects that do not have a firm commencement date at the time of application, but makes no allowance for significant projects that are unforeseen but become necessary within the regulatory period.

The revenue reset process requires TNSPs to project revenue requirements for a five year regulatory period. Projections must be finalised some 14 or 15 months prior to the onset of the new regulatory period. This is an inherently complex process, given the dynamic nature of transmission network environments and the fact that infrastructure projects are often uncertain and have short lead times – generally much less than five years. This presents significant risks for TNSPs, which must maintain service standards irrespective of changes in their operating environments. As electricity is an essential service in our society, and key to the delivery of much essential infrastructure, the contingent projects provision is critical to the overall effectiveness of the Rule.

The Draft Rule mandates that contingent project status may only be afforded to a project assessed by the AER to be: *'reasonably required to be undertaken in order to:*

(i) efficiently meet the expected demand for prescribed transmission services over the relevant regulatory control period;

(ii) comply with all applicable regulatory obligations associated with the provision of prescribed transmission services;

(iii) maintain the quality, reliability and security of supply of prescribed transmission services; or

(iv) maintain the reliability, safety and security of the transmission system through the supply of prescribed transmission services'.

Flexibility

Criteria for contingent projects specifically exclude projects that may be considered speculative. This includes projects such as the Gold Coast desalination plant, which was confirmed in August 2006, with early works due to commence this month (September 2006). This project will create a spot load of some 80 megawatt (MW), requiring a transmission augmentation project of some $37 million well before mid-2012, when the relevant revenue cap will cease. The need to fund such projects would require Powerlink to defer other committed projects. This example reflects the need to respond to matters of urgency, such as Queensland's current water crisis, as they arise. Without the flexibility to provide for such events, this Rule is likely to adversely impact upon the delivery of urgent essential infrastructure in Queensland.

It is noted that the contingent projects list presents no risk to the AER, as all new transmission projects with a capital outlay of more than $1 million must pass the Regulatory Test, which is designed to ensure that transmission investment is both prudent and efficient. Such proposals must be assessed as the most economically efficient solution against a range of options and either: be required to ensure reliability of supply; or provide a net economic benefit to the market. The list of contingent projects is useful in ensuring that the potential for 'double dipping' with contingent projects is eliminated. However, the lead times for mining and export infrastructure projects demand funding within a shorter timeframe than the six-plus year projection horizon available to TNSPs. The contingent projects provision must provide greater flexibility to ensure it does not impact upon the delivery of key infrastructure in Queensland.

Regulatory Efficiency

It is essential that the process to determine whether the cost of a triggered contingent project may be recovered is as efficient as possible, so as not to delay the commercial decisions of both the TNSP and organisations responsible for providing any down-stream infrastructure that relies upon the development of the contingent project. The decision-making timeframe of 30 business days from receipt of the application will foster the requisite responsiveness.

To foster efficient outcomes, it is important that the criteria applications must satisfy are streamlined wherever possible. An obvious opportunity for such streamlining relates to the definition of contingent projects. If the minimum capitalised value required to qualify as a contingent project equals, or exceeds, the cut-off for which the Regulatory Test for new large network assets is incurred, unnecessary duplication may be avoided. Registration of approved triggers, as provided for under the Second Draft Rule, should expedite this process, through enabling contingent approval.

The process must not unreasonably prevent timely electricity access to industry, which could disrupt and undermine economic development. This objective might most effectively be assured through introducing an economic efficiency over-ride mechanism for all projects that satisfy the Regulatory Test. The Taskforce Report makes the point that export oriented activities operate in fast changing world markets, where delays can translate into unacceptable losses in competitiveness.

By definition, the nature of a contingent project trigger is that its occurrence makes the contingent project reasonably necessary to meet the TNSP's service obligations. Accordingly, when a contingent project is triggered, it is important that the Regulatory Test proceed as quickly as possible. All transmission augmentation projects of more than $10 million are subject to the full regulatory test, which includes significant requirements for consultation. It is not clear why the AER would need to conduct a second consultation program in parallel with that conducted by the TNSP. This appears excessive and would impose unnecessary delays.

Threshold

To qualify as a contingent project, each must represent capital expenditure that exceeds five percent of the opening RAB for the regulatory period. This benchmark is the same as that identified for revenue reopening, which is intended to address only *force majeure* (or shipwreck) events.

The scale of this benchmark is too high to be of relevance to TNSPs with large RABs, such as in Queensland, where it appears unlikely to ever be applied. This renders the provision of limited usefulness as a risk management tool. Based on Powerlink's current Revenue Reset Application, contingent project status would be restricted to individual projects of at least $190 million. A 2005 Pre-Feasibility Study for a 200 MW upgrade of the Queensland – New South Wales Interconnector (QNI) estimated total project costs of $120 million, which would be shared between Powerlink and TransGrid.

The application of a threshold that represents a set proportion of RAB imposes a very different benchmark for each TNSP, which may vary considerably at successive revenue resets, requiring different approaches to managing the risk posed by contingent projects. The degree to which successive revenue applications vary bears little correlation to the risk of contingent projects being triggered.

TNSPs must subject proposed new large transmission assets (those requiring a total capitalised expenditure of over $10 million) to an involved Regulatory Test procedure, including public consultation, to determine the option that most efficiently addresses the identified need. Unless required to maintain reliability of the network, the project may only be developed if it delivers a positive net present value to the market. A streamlined version is also required for small transmission assets of between $1 million and $10 million. A workable alternative to the current Contingent Projects provision might be to adopt the benchmark for large network projects provided for in the Regulatory Test: over $10 million. The consistency of this approach would afford TNSPs certainty, whilst ensuring that any such project does represent an efficient solution to an identified need.

However, this threshold would represent a higher threshold for some TNSPs, inappropriately disadvantaging them. In light of the above comments, DME considers the threshold could be reviewed to cater for all TNSPs including those with larger RABs, such as exist in Queensland by setting it at the lesser of: the threshold for new large transmission assets; or five percent of RAB as submitted by the AEMC.

DME considers the Contingent Projects provision would more usefully relate to the aggregate of projects triggered by a particular extraneous event, rather than an individual project. This would provide for significant departures from input assumptions utilised in forecasting expenditure, such as instances where actual demand growth is well above that forecast. This occurred in Powerlink's current regulatory period, where actual capital expenditure exceeded the allowance by approximately $220 million (20 percent).

Incentive Mechanisms

The provision to carry forward efficiency gains and losses to subsequent regulatory periods is a strong incentive that could prevent TNSPs from recovering their efficient costs. Such a penalty could impact the financial viability of a business, discouraging investment to meet the reliability of supply obligations. Noting the uncertain nature of the environment within which TNSPs operate and the inflexible nature of the reliability standards they must meet, this seems unacceptable.

Deferral of necessary maintenance could lead to reliability outcomes similar to those that prompted the Queensland Government to commission the Somerville Report (Electricity Distribution and Service Delivery for the 21st Century) in 2004. The Report identified that significant reliability concerns in the Queensland Distribution networks at the time were substantially the result of insufficient maintenance and augmentation of the networks over a period of time. The Panel concluded that the distributors had not had sufficient focus on the quality of service delivered.

The Somerville Report stated:

> *'In times of volatile load growth, the revenue cap approach has serious shortcoming because the facts on which the original submissions and determination are based can change significantly during the period ...*
> *In combination with other factors it can, in the Panel's opinion, result in undesirable long term outcomes ... In times of high load growth, this could mean that capital expenditure which should be incurred to maintain and necessarily expand the network may not be spent... If a revenue cap approach is to be used, it should be accompanied by other measures which allow the distributors, in cases where circumstances change significantly, to spend above the amounts included in their submissions without effectively being penalised. The regulatory regime should be more flexible and more focussed on establishing incentives to produce acceptable outcomes. These measures could include a form of 'off ramp' during the regulatory period when outcomes differ materially from forecasts. An off ramp would allow for the revenue cap to be adjusted without the need for a full re-opening of the determination'.*

The Queensland Competition Authority (QCA) prepared an Issues Paper into Efficiency Carryover Mechanisms in 2004. The QCA's Paper identified:

> *'requiring a business to carry forward accumulated losses may not only penalise the business but may also penalise the customer as the business may be forced (or elect) to run down service quality rather than undertake the necessary investment in its infrastructure in the face of less than sufficient revenues. Should efficiency losses accumulate to a significant size, carrying forward losses could potentially threaten the financial viability of the business in a subsequent regulatory period...*
> *A compromise might be to set to zero any carryover between periods where the amount would otherwise be negative, or for the Authority to exercise some discretion in determining the treatment of negative carryover amounts, based on the specific reasons for the result and the likely financial impact on the regulated business.'*

Service Target Incentive Scheme

The increase in the Service Target Incentive Scheme from a maximum of one percent to up to five percent of Maximum Allowable Revenue (MAR) is also considered too high, placing a large proportion of the profit of a regulated business at risk. The proposed future inclusion of market impact measures in this Scheme would raise this risk further. Given the uncertainty of the environment within which the TNSPs operate, the Department considers the earlier one percent threshold more appropriate.