FINAL DECISION

Directlink
Transmission Determination
2020 to 2025

Attachment 6
Operating expenditure

June 2020

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165
Email: AERInquiry@aer.gov.au

AER reference: 62730

Note

This attachment forms part of the AER's final decision on Directlink's 2020–25 transmission determination. It should be read with all other parts of the final decision.

The final decision includes the following attachments:

Overview

Directlink's transmission determination 2020–2025

Attachment 1 – Maximum allowed revenue

Attachment 2 – Regulatory asset base

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment A – Pricing methodology

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6 Operating expenditure

Operating expenditure (opex) refers to operating, maintenance and other non-capital expenses. Forecast opex for prescribed transmission services is one of the building blocks we use to determine a service provider's total revenue requirement.

This attachment outlines our assessment of Directlink's proposed total opex forecast for the 2020–25 regulatory control period.

6.1 Final decision

Our final decision is to include total forecast opex of $23.4 million ($2019–20) in Directlink's revenue for the 2020–25 regulatory control period. Our final decision represents an increase of $1.2 million (5.4 per cent) more than Directlink's actual and estimated opex in the current regulatory control period.

This is our alternative estimate of Directlink's total opex, which is materially different from Directlink's total forecast opex of $28.0 million ($2019–20) in their revised proposal.[1]

We have assessed Directlink's updated opex forecast by comparing it with our alternative estimate of total opex.[2] We used our standard 'base-step-trend' approach to develop our estimate. The total opex forecast we have adopted in this final decision starts with Directlink's actual costs in 2017–18 as a base year. We have then forecast growth in prices, output and productivity and assessed Directlink's step changes in accordance with our *Expenditure forecast assessment guideline* (the Guideline).[3]

Our alternative estimate does not include Directlink's proposed land restoration costs which total $4.6 million ($2019–2020).[4] This is the main difference between Directlink's revised proposal for opex and our estimate. There are still over 20 years until the end of the life of Directlink's regulated interconnector assets and a number of factors, set out in section 6.4.3.1, mean that there is much uncertainty regarding the likelihood and timing of the land restoration costs being incurred. Because of this, we do not consider it to be prudent for a business to recover these costs starting from the next regulatory control period and, as such, are not satisfied inclusion of the land restoration costs reasonably reflects the opex criteria.[5]

Figure 6.1 compares Directlink's updated opex forecast to its past actual opex, our previous regulatory decision and our alternative estimate.

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1 NER, cll. 6A.6.6(d) and 6A.14.1(3)(ii).

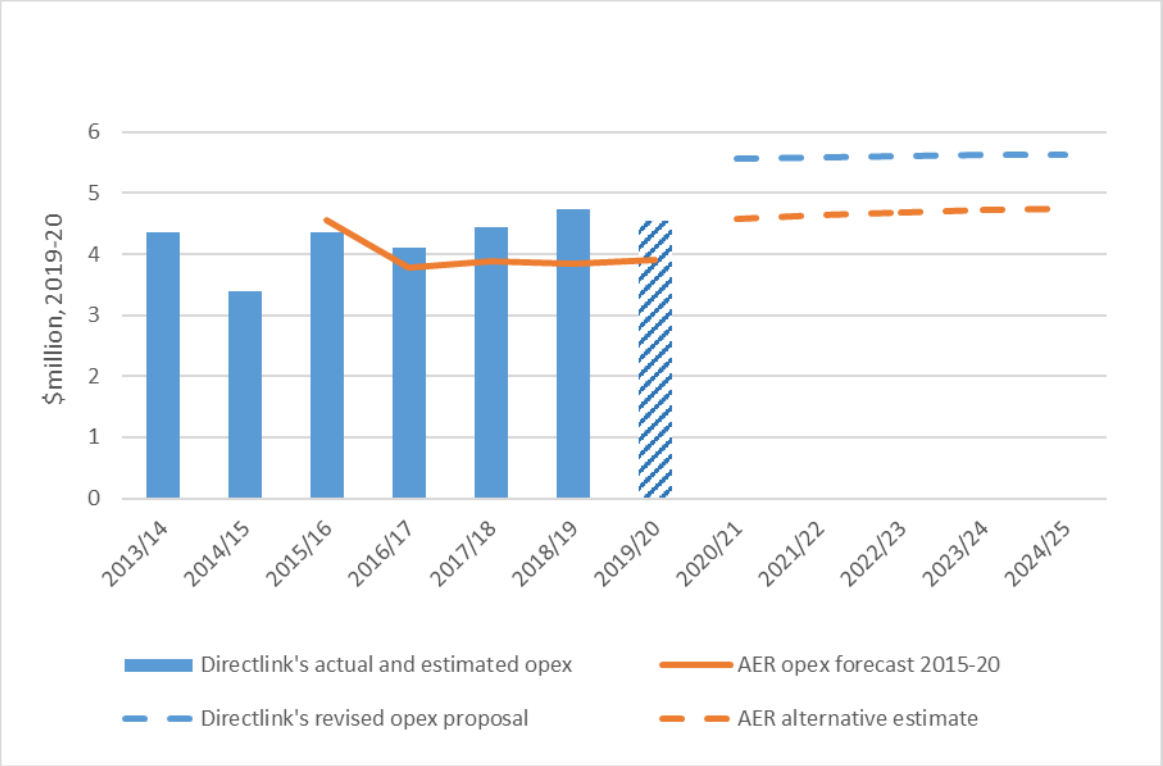
2 Including debt raising costs.

3 AER, *Expenditure Forecast Assessment Guideline for Electricity Transmission,* November 2013.

4 Directlink, *Revised revenue proposal 2020–25,* December 2019, p. 11.

5 NER, cl. 6A.6.6(c).

Figure 6.1 Historical and forecast opex ($million, 2019–20)



Source: Directlink, *Regulatory accounts 2013–14 to 2017–18*; Directlink, *Operating expenditure model*, 10 December 2019; AER analysis.

Note: Includes debt raising costs.

6.2 Directlink's revised proposal

Directlink proposed a total forecast opex of $28.0 million ($2019–20, see table 6.1).[6] The only change between Directlink's revised proposal and our draft decision is the inclusion of a proposed step change for land restoration costs.[7]

Table 6.1 Directlink's revised opex proposal ($million, 2019–20)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Total forecast opex	5.6	5.6	5.6	5.6	5.6	28.0

Source: Directlink, *Operating expenditure model*, 10 December 2019

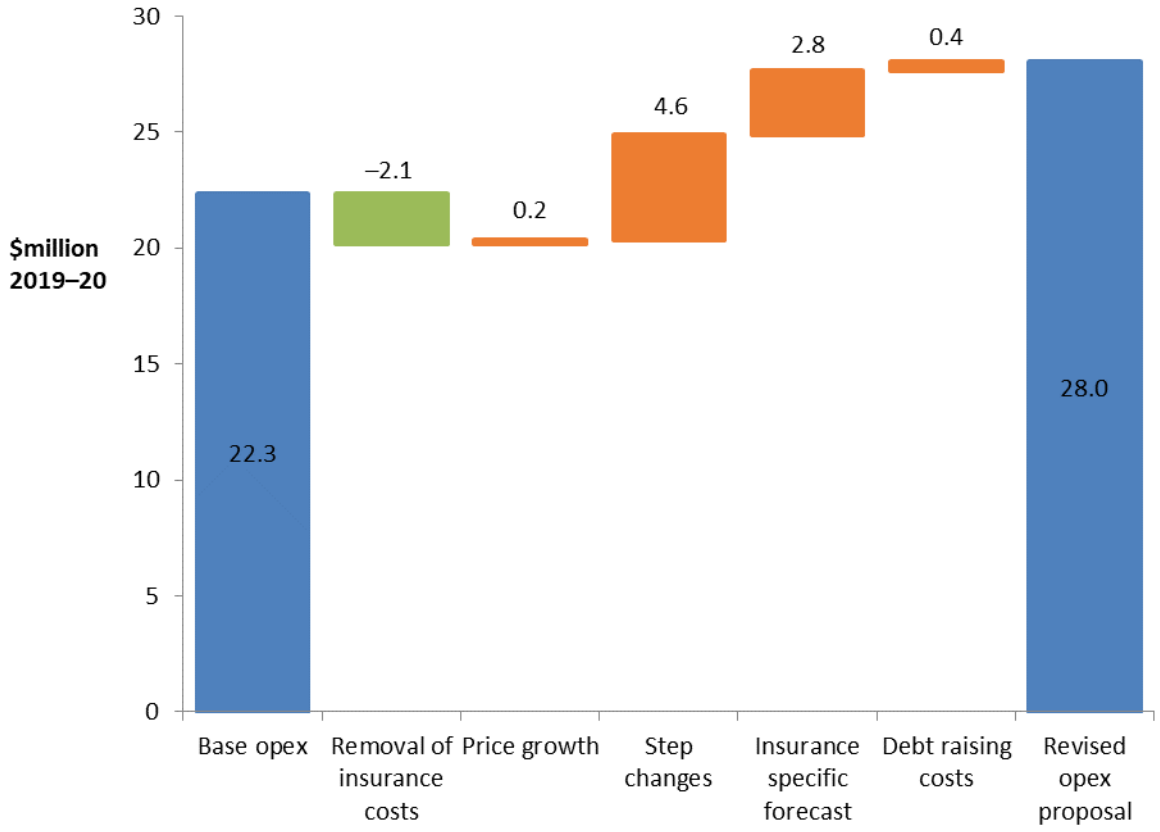
Note: Includes debt raising costs.

[6] Including debt raising costs; Directlink, *Revised revenue proposal 2020–25*, 10 December 2019, p. 11.

[7] Directlink, *Revised revenue proposal 2020–25, December 2019*, p. 11.

In figure 6.2 we separate Directlink's revised opex proposal into the different elements that make up its forecast.

Figure 6.2 Directlink's revised opex forecast ($million, 2019–20)



Source: Directlink, *Operating expenditure model*, 10 December 2019; AER analysis.

6.2.1 Submissions on Directlink's proposal

We received one submission on Directlink's opex revised proposal from the Public Interest Advocacy Centre (PIAC).[8] PIAC stated that, overall, it was pleased Directlink accepted many aspects of our draft decision. It also noted support, in principle, for Directlink's proposal for recovering efficient land restoration costs from customers that benefit from Directlink, using a robust and transparent methodology that is used by other relevant regulators.

[8] Public Interest Advocacy Centre, *Submission on Directlink 2020–25 revised revenue proposal,* 15 January 2020, p. 2.

6.3 Assessment approach

Our role is to decide whether to accept a business' total opex forecast. We are to form a view about whether a business' forecast of total opex 'reasonably reflects the opex criteria'.[9] In doing so, we must have regard to the opex factors specified in the National Electricity Rules (NER).[10]

The Guideline, together with an explanatory statement, sets out our assessment approach in detail.[11] While the Guideline provides for greater regulatory predictability, transparency and consistency, it is not mandatory. However, if we make a decision that is not in accordance with the Guideline, we must state the reasons for departing from the Guideline.[12]

Our approach is to assess the business' forecast opex over the regulatory control period at a total level, rather than to assess individual opex projects. To do so, we develop an alternative estimate of total opex using a 'top-down' forecasting method, known as the 'base-step-trend' approach.[13] We compare our alternative estimate with the business' total opex forecast to form a view on the reasonableness of the business' proposal. If we are satisfied the business' forecast reasonably reflects the opex criteria, we accept the forecast.[14] If we are not satisfied, we substitute the business' forecast with our alternative estimate that we are satisfied reasonably reflects the opex criteria.[15]

In making this decision, we take into account the reasons for the difference between our alternative estimate and the business' proposal, and the materiality of the difference. Further, we take into consideration interrelationships between opex and the other building block components of our decision.[16]

Figure 6.3 summarises the base–step–trend forecasting approach.

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9 NER, cl. 6A.6.6(c).

10 NER, cl. 6A.6.6(e).

11 AER, *Expenditure forecast assessment guideline for electricity transmission*, November 2013; AER, *Expenditure forecast assessment guideline*, *Explanatory statement*, November 2013.

12 NER, cl. 6A.2.3(c).

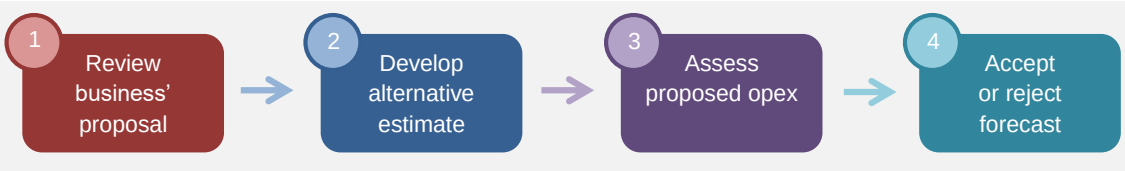
13 A 'top-down' approach forecasts total opex at an aggregate level, rather than forecasting individual projects or categories to build a total opex forecast from the 'bottom up.'

14 NER, cl. 6A.6.6(c).

15 NER, cll. 6A.6.6(d) and 6A.14.1(3)(ii).

16 NEL, s. 16(1)(c).

Figure 6.3 our opex assessment approach



1. Review business' proposal

We review the business' proposal and identify the key drivers.

2. Develop alternative estimate

Base

We use the business' opex in a recent year as a starting point (revealed opex). We assess the revealed opex (e.g. through benchmarking) to test whether it is efficient. If we find it to be efficient, we accept it. If we find it to be materially inefficient, we may make an efficiency adjustment.

Trend

We trend base opex forward by applying our forecast 'rate of change' to account for growth in input prices, output and productivity.

Step

We add or subtract any step changes for costs not compensated by base opex and the rate of change (e.g. costs associated with regulatory obligation changes or capex/opex substitutions).

Other

We include a 'category specific forecast' for any opex component that we consider necessary to be forecast separately.

3. Assess proposed opex

We contrast our alternative estimate with the business' opex proposal. We identify all drivers of differences between our alternative estimate and the business' opex forecast. We consider each driver of difference between the two estimates and go back and adjust our alternative estimate if we consider it necessary.

4. Accept or reject forecast

We use our alternative estimate to test whether we are satisfied the business' opex forecast reasonably reflects the opex criteria. We accept the proposal if we are satisfied.

If we are not satisfied the business' opex forecast reasonably reflects the opex criteria we substitute it with our alternative estimate.

6.4 Reasons for final decision

Our final decision is to include a forecast opex of $23.4 million ($2019–20) in Directlink's revenue for the 2020–25 regulatory control period. We consider that this forecast reasonably reflects the opex criteria, taking into account the opex factors.[17]

[17] NER, cll. 6A.6.6(d) and 6A.14.1(3)(ii).

Our total opex forecast is $4.6 million (16.6 per cent) lower than Directlink's total revised opex forecast of $28.0 million ($2019–20).[18]

Our alternative estimate for total opex of $23.4 million ($2019–20) is materially different from Directlink's forecast. Therefore, we are not satisfied Directlink's proposed forecast reasonably reflects the opex criteria.[19] Because of this we have used our alternative estimate as Directlink's forecast total opex for the 2020–25 regulatory control period.

Table 6.2 compares the differences between our alternative estimate and Directlink's revised proposal. Our forecast differs from Directlink's because:

- we did not include a step change for land restoration costs
- consistent with our draft decision, we used our Guideline approach to forecast the change in opex between the base year (2017–18) and the final year of the current regulatory control period (2019–20) to ensure consistency with our calculation of efficiency benefit sharing scheme carryover amounts. This can be seen as the differences in base opex (based on reported opex in 2017–18) and the 2017–18 to 2019–20 increment
- we updated our alternative estimate from the draft decision:
    - we use the most recent trimmed mean inflation forecast to adjust nominal numbers to real numbers.[20] Our usual implementation is to use the (headline) consumer price index (CPI) forecast for the year ending June 2020. In the current COVID circumstances, we consider that the trimmed mean forecast better reflects core expectations of inflation as set out in the RBA's *Statement on Monetary Policy*. Further, the trimmed mean smooths the transient volatility in the CPI forecasts in the May *Statement on Monetary Policy*.
    - we use an average of the most recent New South Wales real wage increase forecasts produced by Deloitte Access Economics and BIS Oxford Economics to forecast real price growth, weighted by the transmission industry average of labour and non-labour mix.[21]

[18] Including debt raising costs.

[19] NER, cl. 6A.6.6(d).

[20] Reserve Bank of Australia, *Statement on Monetary Policy - Appendix Forecasts*, May 2020.

[21] Deloitte Access Economics, *Labour Price Growth Forecasts prepared for the AER*, 24 June 2019, p. xiii.

Table 6.2 Our alternative estimate compared to Directlink's revised proposal ($million, 2019–20)

	Directlink	Our alternative estimate	Difference
Based on reported opex in 2017–18	22.3	22.2	-0.1
Efficiency adjustment	0.0	0.0	0.0
Remove insurance from final year estimate	-2.1	-2.1	0.0
2017–18 to 2019–20 increment	0.0	-0.2	-0.2
Output growth	0.0	0.0	0.0
Price growth	0.2	0.4	0.2
Productivity growth	0.0	0.0	0.0
Step changes	4.6	0.0	-4.6
Insurance	2.8	2.7	0.0
Debt raising costs	0.4	0.4	0.0
Total opex	**28.0**	**23.4**	**-4.6**

Source: Directlink, *Operating expenditure model*, 10 December 2019; AER analysis.

Note: Numbers may not add up to total due to rounding.

We discuss the components of our alternative estimate below. Full details of our alternative estimate are set out in our opex model, which is available on our website.

6.4.1 Base opex

We have used the opex Directlink incurred in 2017–18 to forecast its total opex. Using our Guideline approach to forecast the change in opex between the base year (2017–18) and the final year of the current regulatory control period (2019–20), we have estimated a base opex of $22.2 million ($2019–20).

In our draft decision we considered the appropriateness of using Directlink's opex in 2017–18 to estimate its efficient opex requirements for the 2020–25 regulatory control period. We were satisfied that it was appropriate to do so as:[22]

- Directlink currently faces incentives to maximise its profits by incurring only efficient costs and this gives us comfort to rely upon its revealed costs in forecasting opex for the 2020–25 regulatory control period

[22] AER, *Draft decision, Directlink 2020–25 Attachment 6 - Operating expenditure,* October 2019, pp. 12–13.

- taking into account factors that contributed to increased opex requirements from 2016–17 onwards, we were satisfied that Directlink's 2017–18 opex is not materially inefficient and representative of its opex requirements going forward.

We have forecast Directlink's insurance premium costs separately in our alternative estimate, so we have removed Directlink's insurance costs of $2.1 million ($2019–20) from base opex to avoid double counting. This is consistent with our draft decision.

6.4.2 Rate of change

We trend the base opex forward to account for the forecast growth in prices, output and productivity. We refer to this as the rate of change.

We have forecast an average annual rate of change of 0.65 per cent. It is attributable entirely to forecast price growth. We have forecast no output or productivity growth, consistent with our draft decision.

Forecast price growth

We have forecast real average annual price growth of 0.65 per cent in our alternative opex forecast. This increased our alternative estimate of total opex by $0.4 million ($2019–20).

Consistent with our draft decision, our price growth forecast is a weighted average of forecast labour price growth and non-labour price growth.

To forecast labour price growth, we use an average of the real wage price index (WPI) growth forecasts for the relevant jurisdictions' electricity, gas, water and waste services (utilities) sector produced by Deloitte and BIS Oxford Economics.

This is in line with our standard approach, and is a change from the approach in the draft decision of using the WPI growth forecasts provided by Deloitte only, which reflected our analysis that over the period 2007 to 2018 Deloitte's real Wage Price Index (WPI) growth forecasts have been more accurate.[23] As discussed in section 6.4 of the SA Power Networks final decision, in light of further analysis and stakeholder feedback, we have reverted to our standard approach.[24] For this final decision we have used WPI forecasts from Deloitte and BIS Oxford Economics which have been updated since the draft decision.

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[23] Stakeholders raised concerns with the labour price growth forecasts in submissions to SA Power Networks' proposal for its 2020–25 revenue determination. Consequently, we analysed how close the forecasts from both Deloitte and BIS Oxford Economics have been to actual WPI growth over the period 2007 to 2018. We found BIS Oxford Economics persistently over-forecast real WPI growth. In contrast, Deloitte's real WPI growth forecasts have been more accurate. See AER, *Draft decision, SA Power Networks distribution determination 2020−25 Attachment 6 – Operating expenditure,* September 2019, section 6.4.2.1.

[24] AER, *Final decision, SA Power Networks 2020–25 Attachment 6 - Operating expenditure*, June 2020.

Consistent with our draft decision, we have applied weights to account for the proportion of opex that is labour and non-labour, based on the transmission industry average (70.4:29.6).[25] This differs from Directlink's approach of using an average of its historical labour and non-labour costs to determine the weights. As explained in our draft decision, we consider the use of industry benchmarks better incentivises Directlink to reveal its efficient costs[26].

Forecast output growth

We have not included any forecast output growth. This is consistent with our draft decision and Directlink's revised proposal. It is also consistent with our capital expenditure (capex) decision for Directlink, which does not include any expansion capex in the 2020–25 regulatory control period.[27]

Forecast productivity growth

We have not included any forecast productivity growth. This is consistent with our draft decision and Directlink's revised proposal.

Ideally we would forecast opex productivity growth based on past industry average productivity growth to the extent we think it represents business-as-usual conditions. However, we are not able to measure industry opex productivity growth for interconnectors. There is insufficient data to do so.

6.4.3 Step changes

We have not included any step changes in our alternative estimate of Directlink's forecast opex. Directlink's revised proposal included $4.6 million ($2019–20) for land restoration costs.[28] Our reasoning for not including land restoration costs in our alternative estimate is explained below.

6.4.3.1 Land restoration costs

Background

When the Directlink interconnector was being constructed a Deed of Licence (the licence) was issued from the State Rail Authority of NSW, which allowed Directlink to run its cables through State Rail Authority land. In its initial proposal,[29] Directlink stated

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[25] Economic Insights, *Economic Benchmarking Results for the Australian Energy Regulator's 2017 TNSP Benchmarking Report,* November 2017, p. 7. For more detail on our approach to forecasting price changes refer to AER, *Draft decision, AusNet Services transmission determination 2017–18 to 2021–22*, *Attachment 7*, 20 July 2016, pp. 47–52.

[26] AER, *Draft decision, Directlink 2020–25 Attachment 6 - Operating expenditure,* October 2019, pp. 14–15.

[27] AER, *Draft decision, Directlink 2020–25 Attachment 5 - Capital expenditure,* October 2019, p. 8.

[28] Directlink, *Revised revenue proposal 2020–25,* December 2019, p. 11.

[29] Directlink, *Revenue proposal 2020–25*, January 2019, pp. 69–70.

that at the end of its interconnector's regulatory life in 2041–42, under the licence they are required to return the land to the condition it was in when Directlink commenced construction. Directlink proposed to set aside an annual amount that would be determined using an annuity method. Under this approach, an amount would be recovered every year up until 2041–42 to recover the land restoration costs. This would mean the customers that benefit from Directlink's operations would pay for the land restoration costs. Directlink included $2.1 million ($2019–20) as a capex allowance for land restoration costs in its initial proposal, to be recovered over the 2020–25 regulatory control period.[30]

The AER did not include land restoration costs in our draft decision's alternative estimate. This was due to the following issues:[31]

- the prudency (need and scope) and efficiency (basis of estimation and cost inputs) of the land restoration costs were uncertain and not well justified
- it was not reasonable to classify the land restoration costs as capex.

Directlink addressed some of these concerns in its revised proposal. It included a consultant report produced by GHD which estimated the land restoration costs in more detail.[32] This resulted in a change in the proposed land restoration costs, with $4.6 million being included in the revised proposal instead of $2.1 million. Directlink also proposed the costs as an opex allowance instead of a capex allowance and submitted with its revised proposal a memorandum of legal advice from Gilbert and Tobin stating why it considers the NER would permit the inclusion of future land restoration costs.[33]

However, neither the consultant's report, nor the legal advice provided any greater certainty as to whether these costs would be incurred in 2042. Further it is still unclear what would happen to the collected costs in a scenario where the need for land restoration does not crystallise, and Directlink is not required to carry out remediation works.

The Public Interest Advocacy Centre (PIAC) provided a submission on Directlink's revised proposal, which included the following section on the land restoration costs:[34]

> *"PIAC also supports, in principle, Directlink's proposal for recovering efficient end of life costs in a manner that ensures efficient costs are recovered from the customers benefiting from Directlink and using a robust and transparent methodology used by other relevant regulators."*

Decommissioning costs are incurred in the normal course of network replacement and augmentation and usually capitalised as part of the project costs. However in these

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30 Directlink, *Revenue proposal 2020–25,* January 2019, p. 71.

31 AER, *Draft decision*, *Directlink 2020–25 Attachment 5 - Capital expenditure*, October 2019, pp. 19–22.

32 Directlink, *Attachment 3-2 - Directlink - Allowance for end of life costs,* 10 December 2019.

33 Directlink, *Attachment 3-1 - Gilbert and Tobin - Directlink Final Advice,* 10 December 2019.

34 PIAC, *Submission on Directlink 2020–25 revised revenue proposal*, 15 January 2020, p. 2.

circumstances the land restoration costs would be incurred as a result of the retirement of the entirety of Directlink's regulated assets and are not planned to be incurred in the near future. Given these unique circumstances, we consider these land restoration costs could be classified as operating expenditure but should only be included in our alternative estimate of forecast opex for the next regulatory control period if they are prudent and efficient. A key issue when assessing the prudency of the land restoration costs is whether there is sufficient certainty around whether the land restoration costs will be incurred or not. We do not consider the costs can be prudent where we are not satisfied when they will be incurred or that they will in fact be incurred.

Directlink considers that the land restoration costs will not crystallise until 2042, when it currently expects the interconnector to reach the end of its asset life. However, we consider there are a number of issues which create uncertainty as to when Directlink's interconnector may be retired. This may delay or even nullify the need for the land restoration costs to be incurred. This uncertainty may clear up at a later date, which indicates it would be prudent to delay the acceptance of land restoration costs to a future regulatory determination.

The sections below summarise the issues which create uncertainty around whether or not the land restoration costs will be incurred and assess the benefits and drawbacks of including the land restoration costs in the estimate.

Issues that create uncertainty

What happens if remediation is no longer required at all?

- Directlink's revised proposal did not address this question. When asked this question in an information request, Directlink responded by saying it is unlikely environmental obligations would be reduced to a level that would allow equipment to remain untouched, once Directlink's interconnector ceases to exist.[35] Directlink did not address any other scenario in which the obligation is nullified or explain what would happen in such a situation to funds that are collected but not spent.
- The QNI medium Regulatory Investment Test for Transmission (RIT-T) process to upgrade QNI is expected to start soon, with the expected commissioning date of the upgrade being 2028–29 at the latest.[36] Directlink may be impacted by the QNI upgrade, and how it is impacted will become clear after a suitable range of QNI options have been considered. One of the upgrade options raised by Powerlink and TransGrid in earlier consultation would involve the early retirement of the existing Directlink interconnector and replacing it with a larger HVDC interconnector.[37] Under this option, it is not clear whether the land

[35] Directlink, *response to AER information request #019 - land restoration costs*, 16 March 2020, p. 5.

[36] AEMO, *Draft 2020 Integrated Systems Plan*, 12 December 2019, p. 12.

[37] TransGrid and Powerlink, *Expanding NSW-QLD transmission transfer capacity - Project specification consultation report*, p. 40.

restoration costs would still need to incurred by Directlink. It could be possible for the land restoration costs to be capitalised under the QNI upgrade or no longer required. There may be more certainty regarding this scenario as more details of the QNI upgrade are determined, which should occur over the next few years.

- If land restoration costs are collected but not spent (because the restoration work is no longer required), it is not clear that the NER will allow the AER to rectify this.
- Because of these issues there is uncertainty as to whether remediation will be required. If it is not, then it would not be prudent for Directlink to recover any land restoration costs. Only once this uncertainty clears would it become prudent for Directlink to start recovering the land restoration costs.

What happens if the interconnector's life increases or if the interconnector is replaced?

- The 2042 end of life for Directlink's interconnector is based on the expected technical life of Directlink's converter stations.[38]
- In Directlink's revised proposal they stated that as the expected economic life of Directlink is an input into the annuity calculation, the annual allowance would automatically adjust if the expected economic life changes.[39]
- To operate beyond 2042, Directlink would need to replace the retired assets. If the replacement assets exceed the cost thresholds published by the AER under NER cl. 5.15.3(a) (currently $6 million[40]) then it will be necessary for Directlink to undertake a RIT-T if the replacement assets are to be included in its RAB. When Directlink first became a regulated asset, the regulatory test, the predecessor to the RIT-T, was applied and the investment was found to have a negative net market benefit in most credible scenarios.[41] However, that regulatory test was undertaken in 2005–06 and it is not clear whether the same result would occur under a subsequent RIT-T. Additionally, the maximum net benefit may be negative and still pass the RIT-T if it is needed to meet specified reliability standards or system strength services.[42] In over 20 years' time it may be plausible that Directlink could fulfil these requirements.
- If the interconnector's technical life increases then the incurring of the land restoration costs could be delayed by a few years. This, however, can be reflected in the annuity calculation. On the other hand, if the interconnector is replaced then the land restoration costs may not be required for decades. As this could be a long period of time, the possibility that the interconnector will be

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38 Directlink, *response to AER information request #019 - land restoration costs*, 16 March 2020, p. 2.

39 Directlink, *Attachment 3-2 - Directlink - Allowance for end of life costs*, 10 December 2019, p. 4.

40 AER, *Final determination - Cost thresholds review,* 20 November 2018, p. 14.

41 AER, *Draft decision - Directlink application for conversion and revenue cap,* 8 November 2005, pp. 125–126.

42 NER, cl. 5.16.1(b).

replaced creates uncertainty as to whether Directlink will still be obliged to restore the land to its original state. This is because extending the date the land restoration costs will be incurred increases the chances of an event occurring that could nullify Directlink's obligation (for example, if Directlink is replaced by another business, or if the licence is renewed or renegotiated).

What happens if the interconnector's life decreases or it is retired early?

- Directlink have stated that there are a number of factors that could result in the interconnector's life being shortened, or retired early. Directlink's Deed of Licence with the NSW State Rail Authority runs until 2039, which Directlink have assumed could be extended until 2042. This would require negotiation with the State Rail Authority. Directlink also raised unexpected asset failure as a factor which could cause it to cease its interconnector's operations before 2042. In these scenarios Directlink's obligation to restore the land would still exist (unless otherwise negotiated).[43]
- As mentioned in the QNI discussion above, the QNI upgrade may allow Directlink to be retired early and not have to incur the land restoration costs. It may also be possible that Directlink's interconnector could retire early and incur the land restoration costs before 2042.
- While a reduction in Directlink's interconnector's economic life may reduce the number of years it could recover land restoration costs over (and hence increase the annual allowance recovered from consumers, holding all else constant), it is unlikely this would result in a significant price shock felt by consumers. This is due to similar points raised in the 'negative impact of delaying the restoration cost allowance' section below.

Benefits of delaying the restoration cost allowance

As noted in our draft decision, the need, timing and quantum of the land restoration costs that Directlink may incur should become more certain closer to the time the costs are expected to be incurred, and may therefore be able to be included in an opex expenditure forecast in future.

For example, as we approach 2042, it is likely there will be more certainty around the QNI upgrade (and how this will affect Directlink). If land restoration costs are forecasted starting from a later date, instead of during the current period, then these are likely to be more accurate. This is because they would be forecasted over a shorter period, with more information likely to be available. Because of benefits such as these, delaying the recovery of the land restoration costs to future regulatory control periods may be a more prudent method of cost recovery, compared with recovering the costs starting from the 2020–25 regulatory control period, when the need, timing and cost remain uncertain.

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[43] Directlink, *response to AER information request #019 - land restoration costs*, 16 March 2020, pp, 3, 5.

Negative impacts of delaying the restoration cost allowance

We recognise there may be potential negative impacts for delaying recovery of the land restoration costs. As Directlink stated:[44]

> *"A delay has two major negative impacts. It reduces the period over which the cost can be recovered and reduces the period over which the interest on the existing balance held by Directlink can compound. Directlink proposed an allowance of $0.98m ($FY2042). A delay of 5 years, all other factors remaining the same, increases the allowance to $1.12m ($FY2042)."*

By delaying the start of the allowance, the number of years the allowance would be recovered over would decrease. As the total amount of land restoration costs recovered would not be affected by the delay, a delay would cause the annual allowance to increase. The main concern with an increase in the annual allowance recovered would be the price shock felt by consumers.

However, from Directlink's calculations stated above, the incremental cost of increasing the allowance for consumers (holding all else constant) would be $0.14 million (1.12 million – 0.98 million) ($2041–42) per year, if the allowance was delayed by one regulatory control period. We consider the impact of this increment on existing consumer network costs would be minimal when added to the network costs which are currently passed on to consumers. Consumers are therefore unlikely to feel a price shock as a result of increasing the annual allowance.

Comparing the benefits against the negative impacts of delaying the allowance, it is likely the benefits (reduced uncertainty) would outweigh the negative impacts (increased annual allowance). We therefore consider it would be prudent to delay the potential inclusion of land restoration costs until there is more certainty around their necessity and timing.

Conclusion

Recovery of these costs would be possible where we are satisfied that they reasonably reflect the prudent and efficient costs of achieving the opex objectives. However, at this point in time, the AER considers there is too much uncertainty regarding the likelihood and timing of the land restoration costs being incurred. Because of this uncertainty, we do not consider it would be prudent to include the land restoration costs in our alternative estimate of total opex and, therefore, are not satisfied inclusion of the costs would reasonably reflect the opex criteria. After balancing the benefits and negative impacts of delaying the restoration cost allowance, we consider inclusion of the land restoration costs is more likely to be prudent when some of the uncertainty clears. Accordingly, we have not included Directlink's proposed land restoration costs in our alternative estimate of total opex for the 2020–2025 regulatory control period.

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[44] Directlink, *response to AER information request #019 - land restoration costs*, 16 March 2020, p. 6.

6.4.4 Category specific forecasts

As per our previous approach, we have included two category specific forecasts for debt raising costs and insurance costs in our alternative estimate.

Our preferred forecasting approach is to forecast opex using base opex and the rate of change. However, in limited circumstances, we may forecast a particular category of opex independently of the base opex. For example, this may be to ensure consistency with other parts of the building block model. Alternatively, we may use a category specific forecast if a particular opex category is very volatile and causes total opex to become so volatile that it no longer follows a predictable path over time. That is, if we isolate that opex category, our base opex forecast trended forward by the rate of change would be more reflective of the business' total opex.

Debt raising costs

We have included $0.4 million ($2019–20) debt raising costs in our alternative estimate, which is not materially different from Directlink's forecast debt raising costs.

Debt raising costs are transaction costs incurred each time a business raises or refinances debt. Our preferred approach is to forecast debt raising costs using a benchmarking approach rather than a service provider's actual costs in a single year. This provides for consistency with the forecast of the cost of debt in the rate of return building block. We discuss this in section 2.2 of the final decision Overview.

Insurance costs

We have forecast Directlink's insurance costs of $2.7 million ($2019–20) as a category specific forecast, consistent with our draft decision.[45]

6.4.5 Interrelationships

In assessing Directlink's total forecast opex we took into account other components of its proposal, including:

- the EBSS carryover
    - the level of opex used as the starting point to forecast opex (the final year of the current period) should be the same as the level of opex used to forecast the EBSS carryover. This consistency ensures that the business is rewarded (or penalised) for any efficiency gains (or losses) it makes in the final year the same as it would for gains or losses made in other years
    - in calculating Directlink's carryover amounts from the 2015–20 regulatory control period, we have excluded categories of opex not forecast using a

[45] AER, *Draft decision*, *Directlink 2020–25 Attachment 6 - Operating expenditure*, October 2019, pp. 17–19.

single year revealed cost approach for the regulatory control period beginning in 2020, which are debt raising costs and insurance costs

- the operation of the EBSS in the 2015–20 regulatory control period, which provided Directlink an incentive to reduce opex in the base year
- the impact of cost drivers that affect both forecast opex and forecast capex. For instance, forecast labour price growth affects forecast capex and our price growth forecast used to estimate the rate of change in opex
- the classification of particular expenditure and how to account for them in our expenditure forecasts, such as Directlink's proposed land restoration costs
- the approach to assessing the rate of return, to ensure there is consistency between our determination of debt raising costs and the rate of return building block.

Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	annual service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CESS	capital expenditure sharing scheme
CPI	consumer price index
EBSS	efficiency benefit sharing scheme
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
WACC	weighted average cost of capital