# Memorandum of advice

**Date**: 9 December 2019

**To:** Anthony Weaver, Mark Allen

**From:** Geoff Petersen

**Matter No:** 1041124

**Subject** **Directlink end of life cost**

---

## 1 Summary

Directlink is subject to licence obligations which require it to restore the land corridors it uses back to the condition they were in when the licence was granted. These obligations are expected to crystallise when the interconnector is decommissioned and ceases to provide transmission services, which is expected to occur around 2042. The cost of restoration is expected to be around $14.3 million.

Directlink has proposed that the costs of remediation be recovered over the remaining life of the interconnector assets. In its initial revenue proposal for the 2020-25 period, Directlink proposed that an amount be capitalised in each year until decommissioning to cover the anticipated future land restoration cost. In its revised revenue proposal, Directlink has proposed that an amount be included in its operating expenditure allowance to provide for this future cost.

We have been asked whether the inclusion of an allowance for these future remediation costs would be consistent with the National Electricity Rules (**NER**).

In our opinion:

- Directlink's obligation to remediate the land corridors that it uses is a regulatory obligation associated with the provision of prescribed transmission services;
- accordingly, Directlink should be provided with a reasonable opportunity to recover the efficient costs of complying with this obligation;
- an allowance for operating expenditure may be made under the NER in advance of the regulatory obligation crystallising – the NER do not prevent an allowance being made for the anticipated future costs of a known regulatory obligation;
- indeed, in order to ensure that Directlink has a reasonable opportunity to recover the efficient costs associated with this regulatory obligation, it is likely to be *necessary* for an allowance to be made in the regulatory periods prior to decommissioning;

- we agree with the AER that, if Directlink had sought to classify the allowance as capital expenditure, it is not clear how this allowance could have been rolled into the regulatory asset base (**RAB**) at the end of the regulatory control period. However this issue no longer arises, as Directlink now proposes to treat the allowance as operating expenditure;
- if the AER is satisfied that the proposed operating expenditure allowance to account for recovery of the future remediation costs is prudent and efficient, it must approve the proposed allowance as part of Directlink's total operating expenditure.

We note that there is precedent for making annual cashflow allowances for anticipated future remediation costs in other regulated industries. Under the Queensland port access regime, which includes similar statutory objectives and pricing principles to the National Electricity Law (**NEL**), allowances are frequently made for anticipated future rehabilitation costs of coal terminals.

The remainder of this memo explains the basis for these conclusions.

---

# 2 Background

## 2.1 Directlink's land rectification and restoration obligations

Directlink's Deed of Licence with the State Rail Authority of NSW dated 17 September 1999 requires it to return the easements it uses back to the condition they were in when the Lease was granted.[1] Directlink will be required to undertake restoration works upon expiry or termination of Directlink's licence or any further licence granted to Directlink. Directlink's current Deed of Licence is due to expire on 17 September 2039.

Directlink expects its legal restoration obligations will crystallise when the interconnector ceases to provide prescribed services, currently expected in 2041–42 due to the finite technical life of the Directlink assets. It is expected that this will coincide with expiry or termination of Directlink's Deed of Licence.

Directlink expects the cost of restoration to be around $14.3 million.

## 2.2 Directlink proposal for recovery of land rectification and restoration costs

In its initial proposal, Directlink proposed to set aside an annual amount of capital expenditure to cover the anticipated cost of the future land restoration and rectification works. Directlink proposed capital expenditure of $2.1 million in the 2020–25 regulatory control period as an amount to be set aside for this purpose.

## 2.3 AER draft decision

In its Draft Decision, the AER acknowledged that Directlink has an obligation under its Deed of Licence with the NSW State Rail Authority to restore its easements, as well as more general obligations under NSW environmental legislation to avoid pollution and land contamination. The AER also noted submissions from the Public Interest Advocacy Centre (**PIAC**) that annualising the cost of land restoration would prevent the possibility of 'bill shock' to customers at the end-of-life of the asset, and would be consistent with the beneficiary pays principle.[2]

---

[1] Deed of Licence, cl 12(b).

[2] AER Draft Decision, p 5-19.

However, the AER was not satisfied that these costs reasonably reflected the prudent and efficient costs of achieving the capex (or opex) objectives. The AER also considered that it was also not clear how any forecast capex allowed in relation to future costs can be included in Directlink's RAB in accordance with the NER, and therefore how Directlink intends to recover these costs from customers.[3]

### 2.4 Directlink's revised proposal

Directlink's revised proposal is for an allowance to be made as part of its operating expenditure to account for the future remediation obligation. Directlink is no longer proposing any allowance for capital expenditure to account for this obligation.

Directlink is proposing to annuitise the estimated total cost of future rehabilitation. The estimate of future rehabilitation costs includes the cost of:

- removing 36 km of underground cables and cable protection;
- removing 21km of above ground cable, galvanised steel trough and supports; and
- removing all materials, including concrete slab, from the two converter station locations.

---

## 3 Satisfaction of the operating expenditure criteria

### 3.1 NER requirements

Directlink's Revenue Proposal must include the total forecast operating expenditure for the relevant regulatory control period which it considers is required in order to achieve the operating expenditure objectives.[4] The operating expenditure objectives include:

- [to] meet or manage the expected demand for prescribed transmission services over that period; and
- [to] comply with all applicable regulatory obligations or requirements associated with the provision of prescribed transmission services.

The AER must accept Directlink's forecast of required operating expenditure if it is satisfied that the total forecast for the regulatory control period reasonably reflects:[5]

- the efficient costs of achieving the operating expenditure objectives;
- the costs that a prudent operator would require to achieve the operating expenditure objectives; and
- a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives.

For reasons outlined below, we consider that operating expenditure required to comply with Directlink's land restoration obligations will satisfy the operating expenditure criteria if it can be

---

[3] Draft Decision, p 5-22.

[4] NER, cl 6A.6.6(a).

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

demonstrated that the proposed amount and timing of that expenditure reflects the efficient costs of complying with those obligations and the costs that a prudent operator would require to comply. This may include operating expenditure in the 2020-25 regulatory control period (and subsequent periods) even though the obligations are not expected to crystallise until around 2042.

### 3.2 Is the land rectification and restoration obligation a 'regulatory obligation or requirement'?

As noted above, upon expiry or termination of Directlink's Deed of Licence, it will be required to return the easements it uses back to the condition they were in when the Lease was granted.[6]

In our view, Directlink's obligation to restore its easements is a "regulatory obligation or requirement" for the purposes of the NEL and NER. This obligation falls within limb (1)(b)(iv) of the definition in section 2D of the NEL because:

- the obligation to return the easements to their original condition arises under Directlink's Deed of Licence with the NSW State Rail Authority;
- the Deed of Licence is an instrument issued by the State Rail Authority of New South Wales under the Schedule 6A of the *Transport Administration Act 1988* (NSW) (**TAA**);
- in addition to creating the power to issue the Deed of Licence, the TAA also imposes obligations on Directlink as licensee;[7]
- Directlink is subject to further obligations not to pollute or contaminate the land that it uses under the *Protection of the Environment Operations Act 1997* (NSW) (**PEOA**);[8]
- both the TAA and the PEOA are Acts of a 'participating jurisdiction' (New South Wales being a participating jurisdiction within the meaning of section 5 of the NEL[9]); and
- the obligations clearly relate to protection of the environment.

We note that the AER appears to accept in the Draft Decision that the land restoration obligation is a regulatory obligation or requirement for the purposes of the NEL and NER.[10]

### 3.3 Timing of the regulatory obligation or requirement

We note that Directlink's obligation to restore its easements is only likely to crystallise when the interconnector is decommissioned. This is expected to occur around 2042.

In our view, it is not necessary that a regulatory obligation crystallise within a regulatory control period in order for expenditure required to comply with that obligation to be allowable within that period. It may well be prudent and efficient for expenditure to occur in anticipation of a future regulatory obligation or requirement.

---

[6] Deed of Licence, cl 12(b).

[7] TAA, Schedule 6A, cl 8(3).

[8] *Protection of the Environment Operations Act 1997* (NSW).

[9] New South Wales is a participating jurisdiction by virtue of the fact that Part 2 of the *National Electricity (New South Wales) Act 1997* (NSW), which applies the NEL in New South Wales, corresponds to Part 2 of the *National Electricity (South Australia) Act 1996* (SA).

[10] Draft Decision, pp 5-19, 5-22.

We say this for the following reasons:

1 There is a clear textual indication in clause 6A.6.6 that the relevant regulatory obligation may be in a future period. The relevant operating expenditure objective simply refers to compliance with "all applicable regulatory obligations or requirements…" (emphasis added). It is not limited to ensuring compliance with just those regulatory obligations expected to arise or crystallise in the forthcoming regulatory control period. By contrast, the first of the operating expenditure objectives is to "meet or manage the expected demand for prescribed transmission services over that period". The use of these words in the first objective but not the second is an indication that only the first operating expenditure objective (and not the second) should be limited to addressing matters arising the forthcoming period.

2 Such an interpretation is clearly more consistent with the revenue and principles and the national electricity objective (**NEO**). This interpretation ensures that network service providers are provided with a reasonable opportunity to recover at least the efficient costs of complying with all of their regulatory obligations and requirements, including where those obligations do not crystallise until after the cessation of service provision (e.g. upon decommissioning of assets).[11] This in turn promotes efficient investment, since it provides some assurance to service providers that their investment costs (including the costs of regulatory compliance) can be recovered.[12]

3 On the other hand, if allowable operating expenditure for a regulatory control period were limited to that required to comply with obligations crystallising in that period only, it is likely that costs associated with some regulatory obligations would be unrecoverable – an outcome that would clearly be at odds with the revenue and pricing principles and the NEO. The present case is an example of where this could occur, since the obligation to remediate the land it uses will only crystallise once the asset is decommissioned (at which point there will be no services being provided, and therefore no opportunity to recover remediation costs). We note that this is a key reason for the Queensland Competition Authority (**QCA**) allowing recovering of remediation costs through annual cashflows (see section 5 below). The QCA notes that it is in the legitimate business interests of the service provider to seek to recover the costs of remediation while the asset is operational, because once it ceases to operate, there will be no opportunity to collect additional revenue to cover these costs.[13]

4 Our interpretation is also consistent with the available extrinsic material.[14] In developing the NEL revenue and pricing principles, the Expert Panel on Energy Access Pricing explained that the concept of efficient costs is to be assessed "*by reference to all relevant regulatory obligations that exist for a particular service provider*" (emphasis added).[15] The second reading speech introducing the revenue and pricing principles noted that "*at least efficient cost recovery [including recovery of costs associated with regulatory obligations] is vital if service providers are to maintain their electricity networks in order to meet community expectations of the service levels they receive, and to undertake further investment to serve Australia's growing population*".[16]

---

[11] NEL, s 7A(2).

[12] NEL, s 7.

[13] Queensland Competition Authority, Draft decision: DBCT Management's 2015 draft access undertaking, April 2016, p 141.

[14] In the interpretation of a provision of the NEL (including the revenue and pricing principles), consideration may be given to Law extrinsic material capable of assisting in the interpretation, if the provision is ambiguous or otherwise to confirm the interpretation conveyed by the ordinary meaning: NEL, Schedule 2, cl 8.

[15] Expert Panel on Energy Access Pricing: Report to the Ministerial Council on Energy, April 2006, p 113.

[16] South Australia, *Parliamentary Debates*, Legislative Council, 16 October 2007, 883 (P Holloway).

5. In interpretation of the NEL and NER, the interpretation that will best achieve the NEO is to be preferred over any other interpretation.[17] For the above reasons, we consider that an interpretation which allows for recovery in the 2020-25 regulatory control period of costs associated with regulatory obligations which may not arise until after that period best promotes the NEO. Therefore this interpretation is to be preferred over the alternative interpretation.

For these reasons, we consider that the NER would permit an allowance in the 2020-25 period to account for Directlink's known future regulatory obligations (including those arising after the 2020-25 period), provided that this reflects a prudent and efficient means of allowing for those future obligations.

### 3.4 Prudent and efficient costs of complying with the land rectification and restoration obligation

Directlink will need to establish that its proposed allowance for operating expenditure to account for the expected future restoration costs is a prudent and efficient allowance. This is likely to require analysis of the expected future efficient costs of rehabilitation, and consideration of the most prudent means of allowing for this.

We cannot express an opinion on the prudent and efficient means of allowing for the costs of this future obligation. However we would observe that it is unlikely to be prudent to set aside *nothing* for this anticipated obligation, since at the time it crystallises, there will be no capacity to provide services and therefore no means of generating revenue. Therefore the question is unlikely to be *whether* to set aside funds ahead of decommissioning, but rather *how much* to set aside in each period.

If the AER is satisfied that the proposed method for recovery of future restoration costs is prudent and efficient, it must approve the proposed allowance as part of Directlink's total operating expenditure.

## 4 No requirement for costs to be 'incurred' in the 2020-25 regulatory control period

A key concern expressed by the AER in the Draft Decision is that, if expenditure is not 'incurred' in a regulatory control period, it may not be possible to include it in Directlink's RAB under the current regulatory framework.[18]

We agree with the AER that, in order for *capital* expenditure to be included in a TNSP's RAB at the end of a regulatory control period, it needs to have been 'incurred' in that period.[19] There is a question as to whether, if Directlink were to treat its remediation allowance as *capital* expenditure, it could be seen as 'incurred' within the 2020-25 period.

However, as noted above, Directlink now intends to treat the allowance as operating expenditure. Consequently, this issue no longer arises. There is no corresponding requirement for operating expenditure to be 'incurred' within a particular period.

[17] NEL, Schedule 2, cl 7.

[18] Draft Decision, p 5-22.

[19] NER, cl S6A.2.1(f)(1)(i).

## 5 Precedent from other regulated industries

We note that there is precedent for making annual cashflow allowances for anticipated future remediation costs in other regulated industries.

Since privatisation of the Dalrymple Bay Coal Terminal (**DBCT**), the Queensland Competition Authority (**QCA**) has been responsible for regulating access to coal handling services at the terminal.[20] Undertakings are periodically reviewed and approved by the QCA under the *Queensland Competition Authority Act 1997* (Qld) (**QCA Act**) for access to this service. In each of its undertaking reviews, the QCA has included an allowance for end-of-life terminal rehabilitation costs in cash flows (effectively, as part of DBCT Management's operating expenditure allowance). This has been done by annuitizing the estimated total cost of future rehabilitation, using certain assumptions around inflation, interest rates and terminal life.

The QCA has explained the basis for this allowance as follows:[21]

> "The annual remediation allowance aims to provide DBCTM with sufficient funds to meet its rehabilitation obligations under relevant legislation, and pursuant to its lease from the State, at the end of the Terminal's life. Broadly speaking, we consider it is in the legitimate business interests of DBCTM (s. 138(2)(c) of the QCA Act) to seek to recover the costs of remediation while the Terminal is operational—as, once the Terminal ceases to operate, DBCTM will not have the capacity to collect additional revenue to cover these costs."

We note that the statutory object and pricing principles which govern the QCA's decision-making are substantially similar to those in the NEL. The object of Part 5 of the QCA Act is to promote the economically efficient operation of, use of and investment in, significant infrastructure by which services are provided, with the effect of promoting effective competition in upstream and downstream markets.[22] The pricing principles in Part 5 of the QCA Act include that the price of access to a service should generate expected revenue for the service that is at least enough to meet the efficient costs of providing access to the service and include a return on investment commensurate with the regulatory and commercial risks involved.[23] These objects and pricing principles, like those in the NEL, have their genesis in the Productivity Commission's 2001 review of the national access regime and the subsequent COAG Competition and Infrastructure Reform Agreement.[24]

---

[20] Part 5 of the *Queensland Competition Authority Act 1997* (Qld) (**QCA Act**) provides for declaration and regulation of access services. Where a service is declared under the QCA Act, the QCA may accept an undertaking from the service provider which may include prices and other terms and conditions of access. The coal handling service at DBCT has been declared since privatisation of the terminal in 2001.

[21] Queensland Competition Authority, Draft decision: DBCT Management's 2015 draft access undertaking, April 2016, p 141.

[22] QCA Act, s 69E.

[23] QCA Act, s 168A.

[24] Objectives and principles of this nature were originally recommended by the Productivity Commission in its 2001 review of the national access regime, and were subsequently integrated into other access regimes (including the QCA Act regime) pursuant to the February 2006 COAG Competition and Infrastructure Reform Agreement (CIRA). Development of the NEL objective and pricing principles was based on the CIRA and earlier Productivity Commission review, with some refinements (refer to: Expert Panel on Energy Access Pricing: Report to the Ministerial Council on Energy, April 2006, sections 3 and 6).