21 January, 2005

Mr Sebastian Roberts
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Dear Mr Roberts,

Energy Markets Reform Forum:
Comments on TransGrid's and EnergyAustralia's Revised Capex Applications

Please find attached the above comments from Energy Markets Reform Forum as required by Friday 21 January 2005.

Yours sincerely

Mark Gell
Chairman
Energy Markets Reform Forum

Energy Markets Reform Forum:

Comments on TransGrid's and EnergyAustralia's Revised Capex Applications

1. Introduction

The Energy Markets Reform Forum (EMRF) welcomes the opportunity to provide comments on TransGrid's (TG) and EnergyAustralia's (EA) revised capex applications. The EMRF has examined the applications, including the ACCC's consultant's (PB Associates) report on the EA application. Regrettably in the very limited time available for comments on the applications over the holiday period, the EMRF comments are unable to be extensive or detailed.

2. The ACCC's Ex Ante Capex Regulatory Framework

Much has been made by both TG and EA about their level of preparedness with the ACCC's ex-ante capex regulatory framework that will apply to both applications. We have some sympathy for their concerns, as we also have difficulty in getting to grips with the new regulatory framework, access to Commission staff (to the same degree as that available to TG and EA) in clarifying and understanding the ACCC approach, and importantly, whether the ex-ante approach is inconsistent with the code (as suggested by both TG and EA)

Notwithstanding these concerns, it is acknowledged that the ex-ante approach has been part of the process (and debate) involved over a very long time-frame in developing the ACCC's latest draft statement of regulatory principles for transmission networks.

The EMRF also acknowledges that regulatory approaches should not stand still, but should evolve over time to reflect experience and improvements in knowledge associated with regulating transmission networks and to reflect changes in the regulatory environment and context with regard to the latter, exhortations from many stakeholders about the magnitude of network investments required over the next decade or so, must give rise to concerns that such investments must also be efficient and undertaken at least-cost. In this respect, the ACCC's approach, it would seem to the EMRF, is totally consistent with Code provisions regarding efficient investments.

Regulatory experience over the past 6 to 8 years also clearly indicate the need for a new (but not necessarily the ex-ante) capex approach. It is accepted that as it was implemented by regulated businesses and inputs subsequently analysed by regulators the previous ex-post approach, in the experience of the EMRF, was inefficient in that new capex proposals were insufficiently assessed both by proponents and by regulators, sometimes resulting in actual capex coming considerably under capex forecasts. At other times, actual capex spend has been so substantially larger than capex forecast that network service providers were generally provided with windfall gains, as the system for assessing prudency and efficiency was inadequate.

Accordingly, the EMRF reluctantly supports the ACCC's ex- ante cap framework approach. We consider that the approach should reduce regulatory (capex) gaming and has some potential to incentivise efficient investment (e.g. with the difference in revenues between the allowed amount and any capex spend under the cap would be kept by the network business , with the actual amount of investment included in the roll-forward of the asset base) . However we do retain our very real concerns that with the high WACC that is allowed EA by the ACCC, this will actively encourage and incentivise inefficient capital expenditure as there is an expectation that the capex will be automatically rolled into the RAB at the end of the regulatory period.

High yields encourage investment, and if the investment can be made with a guaranteed high return, investors are only too willing to invest in such assets. The EMRF has consistently compared the awarded WACC with equivalent returns earned by industry in a competitive environment and consider that the WACC awarded by the ACCC is excessively high and is, in itself, a significant contributor to the high levels of capex sought by all electricity businesses.

As a counter view, it has been seen that UK regulators tend to use a lower WACC to create some restraint on unnecessary, inefficient or imprudent capital expenditure by regulated businesses. EMRF members are intimately aware of the constraints that a lower return on investment has on an organization's ability to secure capital for new developments or even replacement of existing assets.

Because of this concern we would see that some regular (perhaps annual) audit process of capex commitment is carried out by the ACCC to ensure that both EA and TG have carried out an appropriate examination of the proposed capex at the time it is committed to ensure that it does in fact provide a long term benefit to consumers and other users of the network.

The EMRF notes that there are sufficient safeguards (and discretion available to the ACCC) by way of excluded projects (uncertain and / or large) which could be nominated to be excluded from the cap, and off-ramps, which address circumstances that are unexpected and unforeseen at the time of a regulatory review.

3. PB Associates Report on EA

The EMRF generally agrees with the recommendations of the PB Associates Report on EA's capex application. Of significance is PB Associates observation that EA's total capex forecast for 2004/05 to 2008/09 is approximately double the actual expenditure of the previous 5 year period ($139m) .

PB Associates recommendation that $65.6m of costs can be deferred into the next regulatory period primarily because of projects that are planned for replacement ahead of the time as suggested by their condition assessments. This observation supports our concerns noted above that awarding a high WACC incentivises asset owners to increase capex, or to bring it forward unnecessarily. It would therefore be prudent for the ACCC to accept PB Associates' recommendation for project deferrals.

Whilst PB Associates assessed that EA's new capital governance framework (which was introduced in July 2004)

> " provides a sound basis for the identification, analysis and development of effective network development "[1] It should be noted that EA has acknowledged that the majority of the projects proposed have not been developed within all the requirements of the new framework.

That EA has introduced this new governance framework, but has not used it to demonstrate the prudency of the proposed capex program, raises serious concerns with EMRF members. The ACCC must ensure that EA commits to review all of its planned capex within the bounds of this new governance procedure before allowing EA to roll in the capex into the new RAB.

EA had requested a capex program that nearly tripled the capex of the past regulatory period (from $106m to $284m). Analysis of the PBA recommended capex for the regulatory period indicates that EA would be granted some $218m, more than double the past regulatory period. When this large increase is taken into consideration with the very large capex program that IPART has approved for EA (increasing by over 50%), then the EMRF has very real concerns that EA has the capability to expend this degree of capital whilst maintaining adequate controls and ensuring efficiency and prudency of the total amount

It may well be that delivery of all of these projects may be a challenge for EA during this coming regulatory period. Again, we consider that high regulated WACC's drive high levels of capex.

The EMRF has some sympathy for PB Associates' recommendation to accept EA's IT allocation costs of $15.86m. (given that IPART had finalized its decision on EA's distribution network system) but on the other hand, it is noted that EA has not provide any significant detail about its IT costs upgrades, the expected benefits, or even produced a business case. The ACCC must only accept costs that can be justified and can be shown to be prudent.

4. PB Associates Report on TG

At this stage we have not seen the PBA report on TG revised capex, but we understand that it will be released late in January. The EMRF will provide a response to the PBA recommendations on TG capex after seeing the report.