Our ref: D08/15059

TRANSEND

15 February 2008

Mr Mike Buckley
General Manager Network Regulation North
Australia Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mike,

Submission of the AER's Draft Decision on ElectraNet's Revenue Proposal

ElectraNet submitted its Revenue Proposal to the AER on 31 May 2007. The AER's Draft Decision was published on 9 November 2007 and ElectraNet submitted its revised Revenue Proposal to the AER in response to the Draft Decision on 18 January 2008. Transend Networks Pty Ltd (Transend) welcomes the opportunity to provide this written submission in response to the AER's Draft Decision and ElectraNet's revised Revenue Proposal. Transend would like to submit comments in relation to the following matters:

- Replacement of assets providing transitional services
- Assumptions regarding efficient operating expenditure
- Rationale for adjustments to operating expenditure forecasts
- Escalation rates for capital expenditure
- Risk factors for capital expenditure
- Dynamic ratings and proposed expenditure for weather stations
- The distinction between prescribed and connection services in relation to contingent projects
- The treatment of components of contingent projects, including the impact on equity and debt raising costs
- Inflation assumptions.

Each of these matters is addressed below.

1. Replacement of assets providing transitional services

The new chapter 6A of the National Electricity Rules, together with the Australian Energy Market Commission's (AEMC) Final Determination document, clarify that new connections for generators and directly connected customers (excepting distributors) are not prescribed services, and are to be treated as negotiated or non-regulated services. However, the National Electricity Rules (the Rules) and the AEMC determination are unclear as to the regulatory treatment when existing assets used in the provision of 'grandfathered' prescribed connection services are replaced.

Transend agrees with and supports the reasoning provided by ElectraNet in its Revised Revenue Proposal to continue to treat replacement of these assets as prescribed services, and therefore to include a capital expenditure forecast for replacement of assets providing transitional services. Transend considers that such an approach is consistent with the intent of chapter 6A of the Rules and provides an effective and efficient regulatory approach in situations where assets involved in the delivery of prescribed connection services must be replaced to ensure satisfactory delivery of those services. Transend would appreciate early advice if the AER has a contrary view, as Transend is adopting the same approach in preparing its revenue proposal to be submitted to the AER later this year.

2. Assumptions regarding efficient operating expenditure

Transend notes the AER made the following observations regarding ElectraNet's base year operating expenditure[1]:

> "In considering the efficiency of the base year opex the AER considers that where the proposed base year actual expenditure is close to or less than the efficient allowance provided in the previous revenue cap decision, it is reasonable to accept the base year as an efficient starting point for forecasting."

As a matter of logic, Transend cannot support the AER's proposition that actual operating expenditure is necessarily efficient where it is less than the allowance provided in the previous revenue cap decision. In particular, such an approach presumes that the previous revenue cap decision provided an accurate assessment of efficient operating expenditure. Whilst it is the objective of the revenue setting process to determine efficient operating expenditure allowances, there is obviously scope for error especially as the future is uncertain.

Transend considers that a better approach is to adopt a presumption that the incentive properties provided by the regulatory framework are such that reported operating expenditure is efficient. The rationale for this inferential approach is that CPI-X regulation rewards companies for making operating cost savings and penalises them for over expenditure. Like other companies, network businesses seek to maximise profits within the legal and regulatory framework in which they operate; noting that the companies must meet a number of non-discretionary service and compliance obligations. Therefore, given the CPI-X regulatory framework and the profit-maximising

1 AER, Draft Decision – ElectraNet transmission determination, page 143.

objectives of the firm, it is reasonable to assume that a network business' actual cost is at an efficient level.

As the AER has noted, under the ex ante regulatory framework a service provider retains the benefit (higher profits) of achieving operating expenditure outturns below the level forecast in its revenue determination. If the operating expenditure outturn exceeds the forecast, the service provider suffers an opportunity cost (profits below those implied by the revenue determination).[2] This approach to revenue regulation reinforces that the allowance set by the regulator in the previous period is less relevant to determining efficient costs than the actual level of expenditure incurred by the business.

3. Rationale for adjustments to operating expenditure forecasts

As a matter of principle, Transend cautions against arbitrary percentage reductions in operating or capital expenditure forecasts. In particular, Transend notes that SKM's recommendation that a nominal reduction of 5 per cent for substations and 10 per cent for lines projects appear to be arbitrary. Transend accepts that where the proposed expenditure allowance does not satisfy the requirements of the Rules it is appropriate for the AER to make an adjustment. However, Transend considers that the basis for this decision should be supported by transparent and robust analysis in line with the operating expenditure objectives in the National Electricity Rules.

4. Escalation rates for capital expenditure

Transend notes that the AER has criticised ElectraNet's approach to estimating capital cost escalation rates. In response to the AER's Draft Decision, ElectraNet has adopted an alternative approach to estimating capital costs, strengthening the methodology suggested by SKM and adopted by the AER.

It appears that ElectraNet's methodology is more transparent and comprehensive than SKM's. ElectraNet's methodology appears to incorporate reasonable forecasts for the various cost inputs, based on presently available market data and the composition of its capital program. In comparison, information provided by ElectraNet suggests that SKM's forecasts considerably under-stated the actual input cost escalation rates in 2007. It is also noted that the Post Tax Revenue Model requires inputs in end of year dollars (i.e. escalation to June 2008).

Transend urges the AER to consider the ElectraNet's revised methodology and actual input cost movements when assessing reasonableness of the revised escalation rates provided by ElectraNet.

5. Risk factors for capital expenditure

Transend notes that the AER was critical of the workshop approach adopted by ElectraNet in estimating an overall risk factor that should be applied to capital expenditure forecasts. In the AER's view:

[2] AER, Final Decision – Efficiency Benefit Sharing Scheme, page 4.

- Projected risk profiles and costs were based on the outcomes of a risk workshop and not any systematic evaluation of past evidence of actual occurrences or the actual cost impact;

- ElectraNet has not attempted to moderate the risk workshop outcomes to take account of new initiatives;

- The process inappropriately transfers typical operational business risks that are normally considered as being within the control of ElectraNet's management to users;

- ElectraNet's risk assessment did not identify a sufficient number of cost saving opportunities; and

- Consequently, the AER adopted Powerlink's 2.6% risk factor essentially on the basis that Powerlink assisted ElectraNet in the production of its estimates.

Transend notes that ElectraNet has responded in detail to the AER's comments, and the AER will no doubt conduct a detailed examination of ElectraNet's response. Transend also notes that the AER's recent decision for SP AusNet provides for a risk factor of 2.7%.

Transend remains concerned that the asymmetry present in forecasting future capital program costs – with the likelihood that across the portfolio, costs will be higher than the mid-point of project estimates – is not being appropriately reflected in the AER's decisions and draft decisions. Transend notes that this asymmetry is heightened for companies without the opportunity to mitigate risks across a larger portfolio of capital projects. In terms of general observations, Transend therefore supports ElectraNet's position that "it is reasonable to expect a smaller capital program has a higher risk profile associated with it than a larger one (assuming similar inherent and contingent risks)".[3] Transend encourages the AER to carefully consider the appropriate risk factor to apply to ElectraNet, and not simply be guided by precedent set for companies with differently composed capital portfolios.

6. Dynamic ratings and proposed expenditure for weather stations

The AER reduced ElectraNet's proposed allowance for its weather stations project by $1.9 million. The AER appears to have accepted SKM's statement that[4]:

> "It is noted that the projects are market benefit- rather than reliability- or capacity-driven, and hence the real time ratings are not critical given that default line ratings are always available."

Transend disagrees with SKM's suggestion that the use of weather stations is not critical on the basis that they provide market rather than reliability benefits. The regulatory test, for example, reinforces that both types of benefit are important considerations for investment. Real time ratings deliver valuable market benefits through significant reductions in constraints on elements of the transmission network, and this has been

3 ElectraNet, Revised Revenue Proposal, page 32.

4 AER, Draft Decision - ElectraNet transmission determination, page 244.

recognised by the AER in its service standards reviews. In Tasmania, the use of weather stations to support real time transmission line ratings is a valuable and cost-effective means of maximising the utilisation of, and minimising constraints on, the existing transmission network.

Transend has provided data to ElectraNet regarding estimations of weather station project costs which ElectraNet has referred to in its revised Revenue Proposal. Transend can confirm that ElectraNet's assessment of the likely costs is reasonable based on Transend's experience.

7. The distinction between prescribed and connection services in relation to contingent projects

In the Draft Decision the AER removed the Parafield Gardens West project from the list of proposed contingent projects. The basis for the AER's Draft Decision was that the project did not provide prescribed transmission services, being driven by an expansion of generation services.

In its revised revenue proposal ElectraNet states that[5]:

> "the scope of works is wholly within the shared transmission network and physically removed from any generation connection. The works do not include any new or expanded facilities to connect generation to the transmission network.
>
> ...works to remove constraints on the shared transmission network are by definition prescribed transmission services (provided that a net market benefit is demonstrated by application of the Regulatory Test)"

Based on the information available, Transend supports ElectraNet's view that under the NER, and subject to successful application of the Regulatory Test, this project would provide prescribed, rather than negotiated, services. Transend therefore considers that the project should be included as a contingent project.

8. The treatment of components of contingent projects, including the impact on equity and debt raising costs

Transend supports the AER's decision to transfer the cost of the line works component of Project 10161 (Adelaide CBD) to the contingent projects allowance[6]. Where there is uncertainty associated with a component of a proposed capital project Transend is supportive of the general principle to separate out the component from the forecast capital expenditure allowance for inclusion in the contingent projects allowance. This approach benefits customers and TNSPs.

Transend also notes that ElectraNet's revised Revenue Proposal argues that the AER's conclusion that no equity raising is required to fund the capital expenditure program in the next regulatory control period is dependent on excluding the line component of the

5 ElectraNet, Revised Revenue Proposal, page 39

6 AER, Draft Decision - ElectraNet transmission determination, page 82.

Adelaide CBD capital project from the analysis.[7] In this instance, ElectraNet argues that the line component of the Adelaide CBD project should not be excluded from the analysis to determine benchmark equity raising costs because the project will proceed during the regulatory period.

Transend supports ElectraNet's approach to the issue of equity raising costs. Furthermore, as a general principle it is important that debt and equity raising costs are included in the costs of a contingent project. This principle ensures that TNSPs are not disadvantaged if a project is treated as a contingent project as opposed to being included in the ex ante capital expenditure allowance.

8. Inflation assumptions

Transend notes the AER's approach to forecast inflation in its Draft Decision is to rely on the Reserve Bank of Australia's (RBA) assessment of inflationary expectations. The AER stated in its draft decision[8]:

> "Where the RBA has a bias to tighten monetary policy, inflation will be taken to be at the top of the 2 to 3 percent inflation target range. Where the RBA has a bias to relax monetary policy, inflation expectations will be taken to be at the bottom of the range. Where the RBA has a neutral position, inflation will be taken to be at the mid-point."

Transend further notes that the AER's final decision for SP AusNet's transmission determination (published on 31 January 2008) now recognises that it is appropriate for the AER to make a 10 year forecast of inflation, rather than rely on short-term RBA forecasts. Transend agrees that a 10 year forecast of inflation is appropriate.

Transend would be pleased to discuss any aspects of this submission with you or your staff.

Yours sincerely,

Michael Hunnibell
Executive Manager Revenue Regulation

7 It is noted that according to ElectraNet's cost information templates, the cost of the lines component of this project makes up approximately 14 per cent of the proposed ex ante capital expenditure allowance (refer to page 82 of the AER's Draft Decision – ElectraNet transmission determination).

8 AER, Draft Decision - ElectraNet transmission determination, page 132.