8 August 2014

Mr Chris Pattas
General Manager – Networks Branch
Australian Energy Regulator
GPO Box 520
Melbourne VIC 2601

By email: transendrevenuereset@aer.gov.au

Dear Chris

EUAA Submission on Transend's Revenue Proposal 2014 - 2019

Thank you for the opportunity to make a submission on Transend's Revenue Proposal 2014 – 2019.

The EUAA represents many of the large energy users in Australia in the commercial, industrial and resources sector. Our members account for a significant proportion of the electricity consumed in New South Wales and the National Electricity Market.

Many EUAA members are facing significant challenges due to the rising costs of electricity and are aware that the network charges are a significant component.

Given the long term nature of investment by network businesses that is underwritten by consumers via network charges, our members value the opportunity to provide their perspective in order to assist the AER to make determinations that are aligned to the National Electricity Objective.

The EUAA are encouraged by the efforts of Transend and AER to improve engagement with customers in a meaningful way. There are some significant challenges ahead and the EUAA is keen to work with Transend in finding better ways for the delivery of cost effective and reliable electricity.

We hope you find the enclosed EUAA response of assistance for the AER Draft Determination process and welcome further dialogue or clarification on any of the matters raised.

Yours sincerely

Phil Barresi
Chief Executive Officer
Energy Users Association of Australia

Executive Summary

The Energy Users Association of Australia (EUAA) actively pursues the interests of its members in relation to energy issues impacting their business.

There is significance in the changing situation in regards to recent demand trends, forecast flattening of demand and declining energy outlook via AEMO's recent reports.[1] We are concerned about asset under utilisation trends. It is understood the combination of regulator approved long term network investment and reducing asset utilisation will result in an increase in the unit price of "transport" of electricity.

It is against this backdrop that the need for prudent and efficient investment and expenditure as required by the National Electricity Rules is of paramount interest to EUAA.

The key comments, concerns and issues associated with the Transend's revenue proposal made in this submission are summarised as follows.

1. The **RAB** has significantly increased by 48% over the current regulatory period and it is forecast to increase a further 13%[2] in an environment of significant decline in demand and flat outlook.
2. Whilst proposed augmentation **capex** is lower (80% reduction)[3] than the current period, it is still significant in the context of the significant reduction in demand and requires close scrutiny.
3. The EUAA questions the prudency of the proposed asset replacement **capex** whilst being 40% lower[4] than the current period expenditure it is proposed to be the major driver of the 13% increase in RAB. Many of Transend's assets are at a relatively low average age[5] compared to peer NEM TNSP's.
4. The EUAA questions the prudency of other **capex**, in particular the 53%[6] increase in inventory and 100% increase in operational support systems.
5. The EUAA questions the prudency and legitimacy of the step changes and escalators associated with the proposed 36%[7] increase in controllable **opex**.
6. It is commendable to see Transend propose an initial reduction in opex. It is noted that Transend has proposed an overall expenditure that (in nominal dollars) is the same as the current period.
7. Given the increasing and accumulated level of asset replacement, the EUAA requests clarification on the financial treatment (**return of and on capital**) regarding replaced assets.
8. The EUAA expects the AER to ensure the parameters used in the **STPIS**

[1] AEMO National Transmission Network Development Plan – 2013, AEMO National Electricity Forecast Report – June 2014
[2] Transend Revenue Proposal tables 8.1 an 8.2
[3] Transend Revenue Proposal table 5.4
[4] Transend Revenue Proposal tables 5.6
[5] AER RIN data submitted by TNSPs - May 2014
[6] ibid 3
[7] Transend Revenue Proposal tables 6.4 and 6.16

provide the right incentives to provide tangible benefits to customers.

9. The EUAA would support an incentive framework which does not result in any negative shift in the ratio of network charges allocated to large users and encourages demand management and energy efficiency measures.
10. The EUAA commend Transend for its position in not pursuing under recovered revenue.

The EUAA acknowledges the comments made by the AER in its issues paper associated with the revenue proposal in regard to pursuing many of the issues raised above.

A more detailed exploration of each of the elements of the revenue proposal and other additional commentary follows.

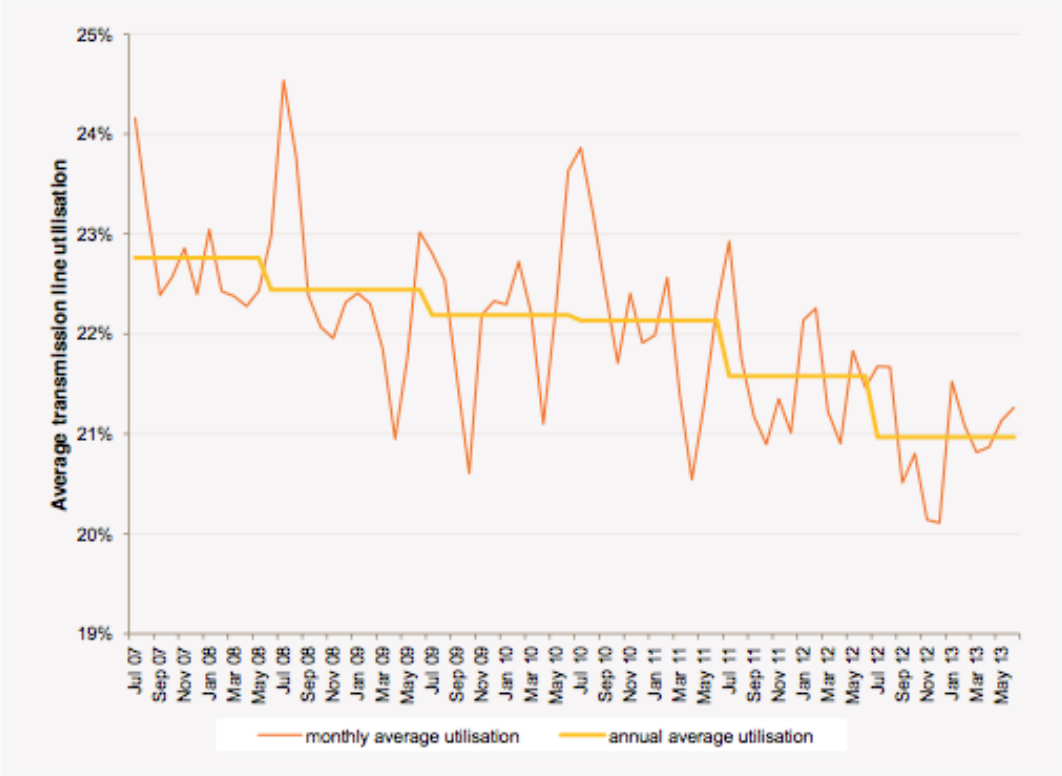
We would welcome further consultation with AER in due course.

Introduction

Investment in the network and associated support costs is dominated by the size of the network. The size of the network is determined by the maximum demand and the reliability standards currently set by each State jurisdictional planner. A significant factor in network charges is the degree of utilization of the network. In other words, it is the amount of energy that is consumed as a percentage of the maximum capacity of the network.

For a number of reasons included in AEMO's National Transmission Network Development Plan 2013, the utilisation of networks across the NEM has fallen dramatically.

Figure 1: Average transmission line utilisation (Source - AEMO National Transmission Network Development Plan 2013)



The Tasmanian network is a winter peaking system. The 10% POE maximum demand in Tasmania is forecast by AEMO[8] to grow by only 0.9% per annum in the short term. The short term forecast energy consumption[9] is a decline of 0.8% per annum. These forecasts are shown in the following diagrams.

[8] AEMO National Electricity Forecasting Report – June2014
[9] ibid 8

Figure 2: Winter 90%, 50% and 10% POE MD forecasts for Tasmania (Source – AEMO National Electricity Forecasting Report – June 2014)

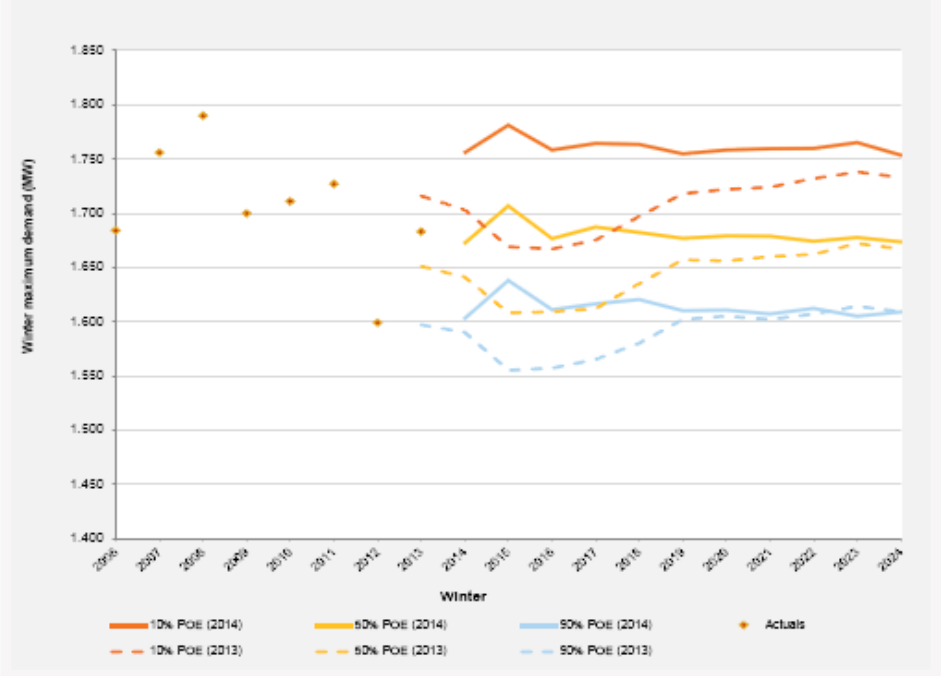
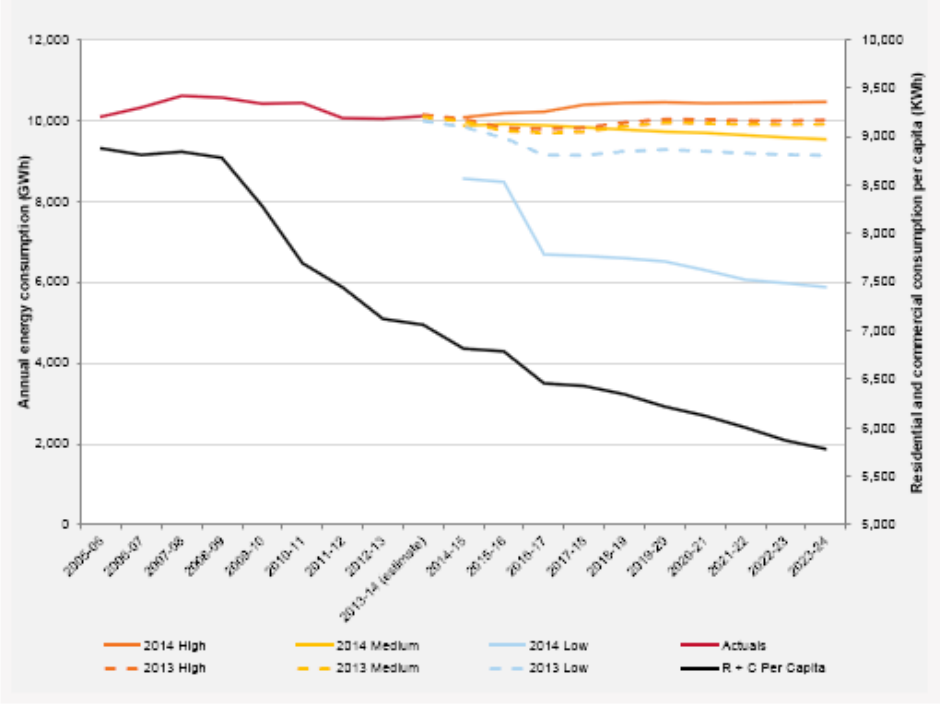


Figure 3: Annual energy forecasts for Tasmania (Source – AEMO National Electricity Forecasting Report – June 2014)



This outlook sends a message that the size of the Transend network business is flat for the foreseeable future acknowledging that AER approved investments to date are locked into Transends revenue allowance.

It is also instructive to compare the above demands to the following demand forecasts presented in Transend's 2009 – 2014 revenue proposal.

Figure 4: Forecast total Tasmanian winter generated MD forecast (MW): 2008-2021 (Source – Transend 2009-2014 Revenue Proposal - page 71)

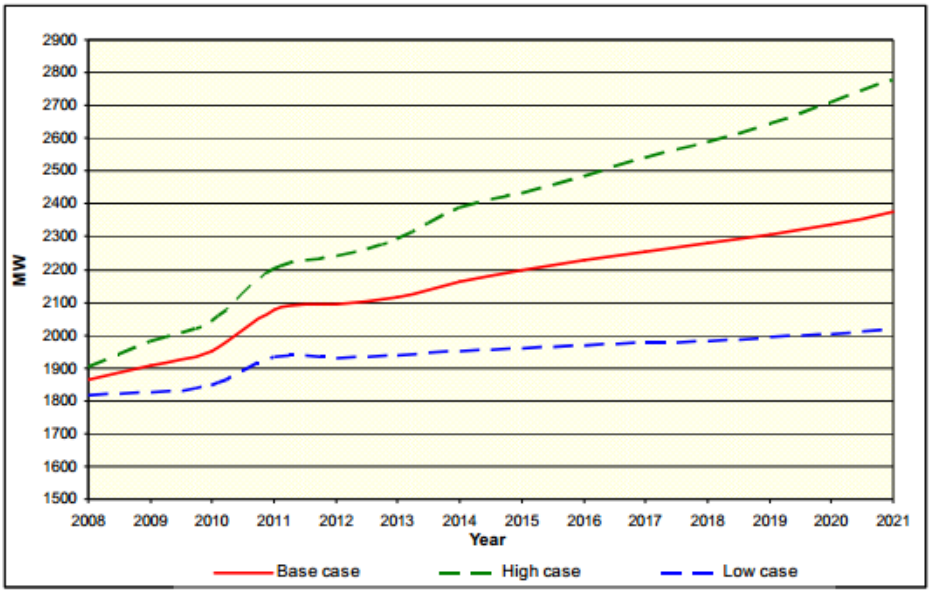
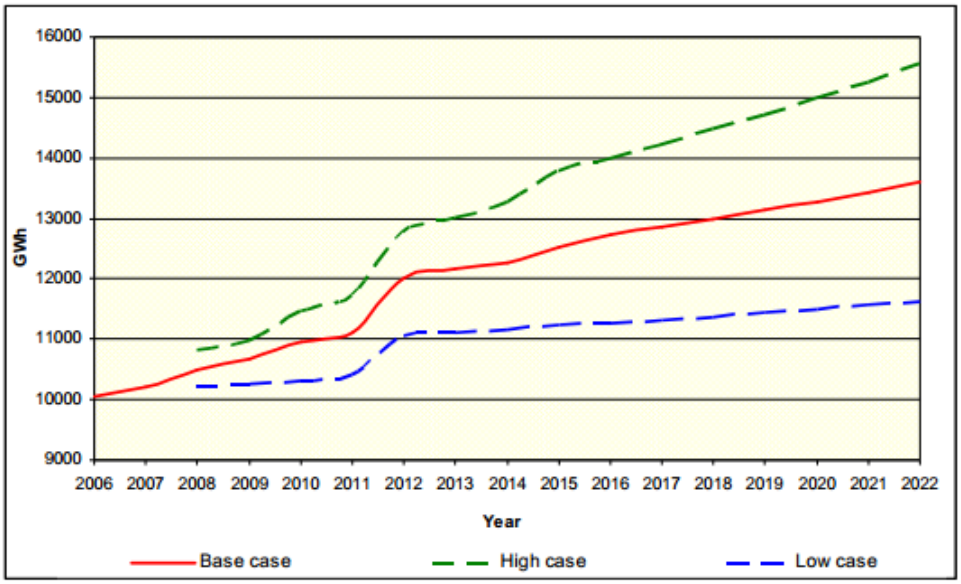


Figure 5: Forecast total Tasmanian electricity sales: 2006-2022 (NIEIR), GWh (Source – Transend 2009-2014 Revenue Proposal - page 70)



The key observations by comparison of the current forecasts compared to the 2009-14 forecasts are:

- the 10% POE demand is now forecast to be significantly lower than the previous lowest case demand forecast and are sitting at 2008 levels.
- the current highest energy consumption forecast is lower than the previous lowest case forecast and are sitting at 2008 levels.

This highlights the level of uncertainty and declining demand trend. It is also noteworthy that Transend's RAB increased by 48% over this same period of declining demand.

The combination of falling demand and an uncertain future in regard to economic conditions, policy, technology and customer response calls for extreme caution in regard to commitment to long term investments that add stress to business competitiveness and community cost of living.

Of concern is that regulated networks business cost recovery is a "zero sum game" and that reduction in utilisation or oversized capacity is simply recovered from connected customers. Falling energy consumption will result in an increasing trend in the ratio of network charges to energy charges.

EUAA is concerned about the future prospect of stranded and over capacity assets in that the current regulatory arrangement transfers all of the financial risk to customers.

We expect to see the AER will address this when reviewing Transend's proposal.

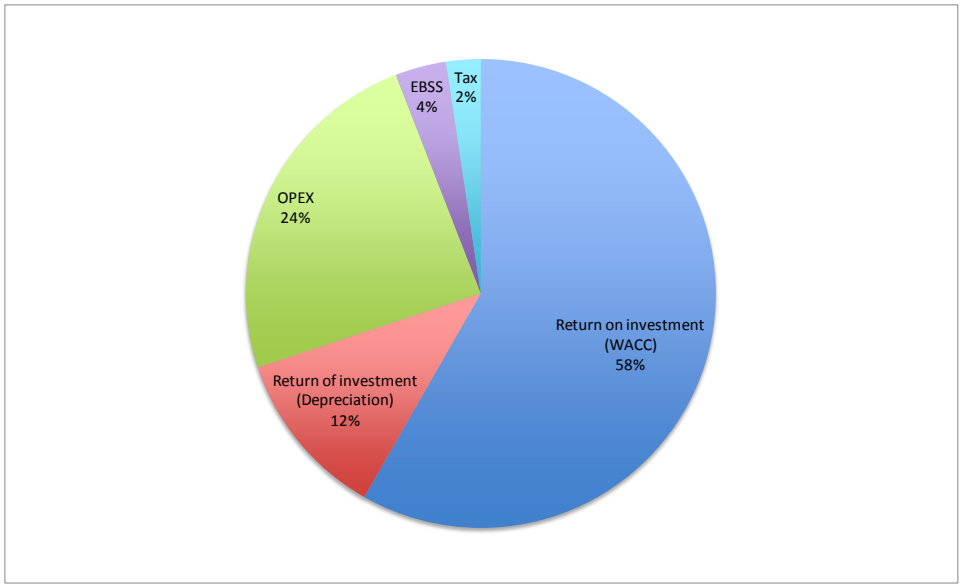
On this basis, at a high level, EUAA has the following broad expectations in terms or revenue building block outcomes.

- All expenditure is demonstrated to be prudent and efficient.
- Rate of return commensurate with regulated low risk businesses.
- Very low levels of augmentation capex – limited only to localised needs.
- Asset replacement capex stringently tested for risks and benefits from a customer and community point of view and wherever possible deferred.
- Other areas of capex – ie - security & compliance and support the business is no more than historic expenditure.
- An efficient level of opex must be demonstrated.

Rate of Return (WACC)

The rate of return is a significant issue in relation to the price to customers.

Figure 6: WACC relativity to total MAR (Source – EUAA based on the Transend Revenue Proposal)



As can be seen by the above chart, return on investment is the most significant portion of the Maximum Allowed Revenue (MAR).

Return on investment = WACC x RAB.

Due to the size of the Regulatory Asset Base (RAB) (current value = $1,412M)[10] small changes in the Weighted Average Cost of Capital (WACC) have large changes in MAR.

As an indication, each 1% change in WACC would have more than $14M / year additional revenue to be recovered from customers. This would equate to over $70M during the next regulatory control period to be recovered from customers.

The EUAA is supportive of the Better Regulation program by the AER and the associated guidelines. However, EUAA members are of the view that the return on investment is very generous for the low level of risk faced by regulated network businesses.

It is acknowledged that the 7.58% WACC proposed by Transend is lower than the AER transitional decision.

We would encourage the AER to re-visit some of the parameters in particular the market risk premium and equity beta to provide a balanced point allocation within the parameter ranges mooted to date by the AER.

[10] Transend Revenue Proposal 2014/15 – 2018/19 table 8.1

Capital expenditure

Network capital investment requires an underwriting by the customer for the life of the asset (up to 50 years). Further, additional capex adds to the RAB, which is a major component of the total revenue.

EUAA acknowledges that the reliability standard for planning in Tasmania is set by the Government at N-1 for loads greater than 25MVA. Transend is obliged via their TNSP licence to meet those standards.

The EUAA would encourage the Tasmanian jurisdiction to consider a more probabilistic approach or at least hybrid taking into account the true value of unserved energy. Given the largest segment of consumed energy in Tasmania is via large customers[11], our members would be very keen to engage in discussion regarding trade off in reliability vs transmission charges.

Augmentation

Whilst the proposed augmentation capex is smaller than the current period, the EUAA expect the AER to challenge all opportunities to defer projects or if appropriate place in the contingent project portfolio.

Replacement

The EUAA members are concerned that Transend are proposing high levels of re-investment in long life assets in an environment where there is a real possibility of those investments continuing to be heavily under underutilised or worse case being stranded.

The proposed replacement program is significant at around $150M and is the main driver of the 13% proposed increase in RAB. Many of Transend's asset classes are at the lower end of the average age range, particularly substation, protection and control assets compared to NEM TNSP peers[12] as shown below.

Table 1: Average age of asset group - NEM TNSP's

AVERAGE AGE OF ASSET GROUP - NEM TNSP's					
2012/13					
	SP - Ausnet	ElectraNet	Transgrid	Powerlink	**Tasnetworks**
TRANSMISSION TOWERS	33.0	42.0	35.4	26.2	**46.9**
CONDUCTORS	33.0	42.0	35.7	23.2	**39.5**
TRANSMISSION CABLES	21.0	8.0	18.5	16.0	**17.2**
SUBSTATION - SWITCHBAYS (INCL. REACTIVE PLANT)	27.0	22.0	25.0	14.1	**15.7**
SUBSTATION - POWER TRANSFORMERS	27.0	29.0	21.0	14.9	**19.9**
SCADA & NETWORK CONTROL MAINTENANCE	6.8	28.0	6.4	9.3	**6.6**
PROTECTION SYSTEMS MAINTENANCE	6.8	18.0	21.7	8.6	**13.1**

It is important that the issue of stranded assets is considered in proposing replacement expenditure. It may well be that the timeframes used in NPV calculations that are presumably used to justify projects is too long given the future uncertainties. Until this issue is resolved, the stranded asset risk continues to be underwritten by customers.

There is clearly not a strong message of "only replace if there is no other option"

[11] Transend Revenue Proposal figure 2.2, section 5.5 6th bullet point
[12] ibid 5

or visibility of the real incremental risk to reliability or safety. Given that the Tasmania reliability standard is generally N-1, what is the real reliability risk of asset failure?

The Transend asset replacement investment process does not appear to consider non network solutions to offset reliability risk acknowledging the RIT-T does not require this.

EUAA believes there should be a strong imperative of deferring network investment as long as possible (ie "sweat the assets") and putting more effort into strategies to minimise future asset stranding risks.

The EUAA expects the AER to adequately scrutinise asset replacement capex with consideration of at least the following:

- the appropriateness of Transend's asset condition assessment and risk management framework versus best practice methodology(eg – risk thresholds, consideration or inherent N-1 reliability, etc)
- consideration of alternative options including - modifying maintenance / monitoring, non network solutions, shorter term refurbishment and other risk mitigation measures.
- review the strategy of replacing whole sites / transmission lines versus asset classes. In particular review the NPV timeframes as it maybe more appropriate in this environment to take undertake shorter term / targeted projects that may appear sub-optimal with a longer term NPV model.
- AEMO's review of "network needs assessment" (future network requirements for major asset replacement areas) - listed in the scope of works Appendix C of the AEMO 2013 NTNDP scheduled to be published 8 August 2014.

The EUAA has some reservations of comparative benchmarks in the area of replacement based on recent RIN information or against NEM peer comparisons as they all appear to be proposing significant raising of expenditure based largely on the age "bow wave" argument and "future price shock, reliability risk", etc. The question stands: “Is this prudent for the next 5 years and what is the real risk of deferral?”

Other Capex

Transend proposes a 53%[13] increase in inventory and 100% increase in operational support systems.

It is rather surprising to see such an increase in operational support systems following a merger that would supposedly highly leverage systems such as those proposed.

We would seek detailed explanation of the increase in these areas in addition to the "business as usual" expenditure level under security and compliance capex.

It is suggested that during the proposal review process, the AER assess Transends risk - benefit framework, its application and alternative considered.

[13] ibid 3

Operating expenditure

The building block revenue model means all AER approved opex goes straight to the MAR - dollar for dollar. The majority of opex categories are recurring in nature.

It is commendable to see Transend propose an initial reduction in opex. It is noted that Transend has proposed an overall expenditure that (in nominal dollars) is the same as the current period. In particular it appears the network maintenance expenditure is very flat in real costs which is surprising given the current and forecast level of renewal capex - circa 30% of the RAB.

The proposed opex is also made in the context of a controllable opex underspend in the current regulatory control period resulting in Transend claiming an aggregate EBSS carryover of some $32M[14].

The EUAA also have some concerns about the prudency of some of the opex step changes and drivers and provide the following comments.

- There does not seem to be any evidence of opex trade off for the proposed increase in replacement capex.
- The transfer of AEMO functions appears to be purely a number based on a previous revenue stream from AEMO that is now being sought to be paid for via the AER process rather than a true incremental cost.
- Labour rate forecast escalators do not reconcile with some of our members experience or views.

DEPRECIATION

The EUAA acknowledge and commend the position taken by Transend in being cognisant of price impacts on customers by extending remaining asset lives that result in a $13M year reduction in MAR.[15]

The historical and proposed levels of asset replacement expenditure beg the question of the financial treatment of assets that are replaced. In a competitive industry, any redundant assets would be written off at depreciated value.

The depreciation schedules provided by Transend do not indicate any write downs / accelerated depreciation which suggests that those “replaced assets” may still be included in the RAB (indexed by inflation) and earning a return in parallel with the replacement assets that have been put in service.

If this is the case, it seems a very favourable arrangement and if allowable under the NER underscores why the regulated businesses are a low investment risk business.

[14] Transend Revenue Proposal table 7.2
[15] Transend Revenue Proposal section 9.3

INCENTIVE SCHEMES

EBSS – Efficiency Benefit Sharing Scheme

The EUAA support the concept of the EBSS provided that the AER approved opex is prudent and efficient and that underspend can be realised by customers rather than overtaken by inflated step changes and escalators.

CESS – Capital Efficiency Sharing Scheme

The EUAA support the concept of the capital efficiency sharing scheme provided that the AER approved capex is prudent and efficientand mechanisms are in place to ensure that there are no windfall gains eg - via reductions in demand.

STPIS – Service Target Performance Incentive Scheme

The EUAA supports the concept of the STPIS provided there is transparency over the setting of targets and appropriate incentive profiles such that bonuses are not paid for "business as usual" performance.

It is noted that Transend have achieved an aggregate of about $2M[16] to date during the current Regulatory period.

With the introduction of the new network capability component, there is an expectation that in light of the flat demand outlook that the value of these projects are closely scrutinised with a highly tangible benefit being able to be transferred to customers ideally within the same regulatory control period.

TRANSMISSION PRICING METHODOLOGY

EUAA members experience network charges that can be a much more significant portion of the energy bill than what is apparent in residential bills[17]. This is further distorted with residential PV where the network charges are picked up by all other users due to energy based tariffs.

EUAA would prefer to see a smoothed approach to transmission pricing rather than a fixed price per 5 year period with the risk of a network price shock every 5 years and supports the proposed methodology of being flexible to changes in regulatory rules and an annual variation to the cap.

EUAA seeks to understand further how the proposed framework would benefit large energy customers in reducing maximum demand.

BENCHMARKING – PRUDENCY AND EFFICIENCY

Transend has produced benchmarking metrics that place them in a favourable light to support their claim to be efficient.

The EUAA is encouraged by the statements in the issues paper on the Transend proposal regarding using RIN data among other types of benchmarking to provide

[16] AER Website - AER response to Transends STPIS compliance reporting
[17] AER Transgrid, Tasnetworks and Directlink – electricity determination - Issues Paper page 15

a more balanced view. We look forward to seeing the results of the AER's assessment of NSP efficiencies in their inaugural report in September 2014.

The EUAA are particularly interested to see metrics that have characteristics including:

- Distinguish and focus on prudency and efficiency rather than entertaining "sales style" headlines eg – "less / within CPI", "impact on bills is only x%", etc
- Include costs that are in the NSP's control
- Are not distorted by customer characteristics – eg use of energy throughput has no bearing on the cost structure of an NSP
- Are normalised where appropriate for differences between NSP's – eg average asset age, different capitalisation policies, etc
- Is more likely to be directly comparable eg unit costs / km, etc
- Appropriate balance between self comparison (historical vs forecast) and other like companies

UNDER RECOVERED REVENUE

The EUAA commend Transend for its position in not pursuing under recovered revenue.