AUSTRALIAN ENERGY REGULATOR REVIEW OF THE TRANSGRID REVENUE PROPOSAL 2009/10-2013/14

AER DRAFT DECISION ON TRANSGRID'S TRANSMISSION REVENUE PROPOSAL & TRANSGRID'S REVISED PROPOSAL

EUAA COMMENTS

20 February 2009

This submission was prepared by the Energy Users' Association of Australia with assistance from McLennan Magasanik Associates. Funding assistance was provided by the Consumers Advocacy Panel. All views expressed are those of the EUAA.

Ref: J1647

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1 EXECUTIVE SUMMARY

The Energy Users Association of Australia (EUAA) welcomes the opportunity to submit the following comments to the Australian Energy Regulator (AER) for its consideration in relation to its final decision on TransGrid's Revenue Proposal 2009/10 to 2013/14.

The EUAA is a non-profit organisation funded by membership fees, internally generated revenue and external funds. It is focused entirely on energy issues and was formed in 1996. Members determine EUAA policy and direction and elect a Board made up of fellow members. The Association's members are business users of energy with activities across all states and many sectors of the economy. The EUAA has over 100 members and this includes most of the largest users in New South Wales and those large users who are directly connected to the TransGrid network.

The following is a summary of the major points made in this submission:

- It is the view of the EUAA that the identified and systemic deficiencies in TransGrid's capital expenditure planning methodology and procedures cannot ensure that the resultant capex program reasonably reflects the capex criteria under clause 6A.6.7(c).
- In relation to TransGrid's planning approach, analysis by PB, and the consideration of this analysis by the AER, found:
  - that economically preferable options have been dismissed on the basis of engineering judgement;
  - that capex costs may be systemically overestimated;
  - that evaluation processes lack auditability;
  - inadequate or non-consideration of likely reasonable options within NPV analysis; and
  - that the NPV assessments underlying several investment decisions have not been complete and often omitted certain costs and benefits.

  These findings are serious and should not be dismissed. The EUAA seeks greater transparency in the assumptions, options, trade-offs and decisions that are made in the process of investment planning.
- While the 2008 APR relied on economic growth projections made by the NIEIR, and while these projections did assume an uncertain economic outlook, the EUAA observes that this outlook is now one year old, and unlikely to be realistic or sufficiently reasonable. The unprecedented and extreme shifts in Australia's monetary and fiscal policy during the past year is evidence of a dramatic and severe change in economic fundamentals. The EUAA therefore does not agree that the demand basis for the capex program is likely to be consistent with the

requirements of the capex criteria of the NER and believes there is strong evidence that it needs to be revised downwards.

- The EUAA does not agree with the AER implication on page 68 of its draft decision paper that capex cost escalators should account for the past commodity boom and skilled labour shortages as these conditions are no longer realistic as an assumption for the duration of the next regulatory period. It is not acceptable to end users that they are required to pay for an out-of-date cost accumulation process and nor should it be to the regulator. The AER indicated at the pre-determination conference that it would be reviewing the cost escalators and we welcome this undertaking.

- The EUAA observes an unprecedented level of uncertainty that presents considerable risk to any large capital expenditure program. This uncertainty is multifaceted, driven by an extreme change in the real economy, a near collapse of the international financial system, and an evolving energy policy that will comprehensively transform the energy industry. It is for these reasons that the EUAA cautions against a large capex program that is largely supply driven, and favours a closer look at demand management/distributed generation initiatives that may defer the need for physical investments, thereby providing time for these uncertainties to sufficiently resolve.

- Given that the timing of the TransGrid revenue reset and the WACC parameter review are closely aligned, the EUAA is of the view that a failure to apply new WACC parameters to TransGrid will make the parameters applied out-of-date, producing an outcome that could distort efficient pricing and investment.

- The EUAA recommends that the AER investigate the outcomes of the DMPP program and whether these potential initiatives were fully represented and assessed as part of TransGrid's expenditure planning process for this revenue reset. The EUAA recognises that demand management initiatives have the potential to delay or avoid high cost alternative investments in physical assets, and that advice of these savings would benefit a revenue proposal, particularly in demonstrating prudence and efficiency in decision making. To the extent that no savings have been identified by TransGrid in its proposal, or revealed via PB's investigations, one may assume that they may not exist. The EUAA therefore questions whether customers are likely to achieve any return for providing TransGrid with this allowance unless a clear benefit can be established.

- The EUAA has major concerns with pass through provisions related to network support events. While it is acknowledged that, in the event of an overspend or underspend, a TNSP must seek a determination by the AER for a variation in a network support pass through amount to customers, the EUAA has concern that regulated businesses, such as TransGrid, will have little if any incentive to draw such matters to the attention of the regulator and end users are not in a well informed enough position identify and act on any underspend events. We therefore recommend that the AER takes steps to mandate the provision of information by regulated businesses to improve transparency in these situations.

- It is not clear from the draft decision to what extent non-regulated activities have been investigated, and to what extent these may overlap with costs that feature in the regulated components of the revenue proposal. The AER should examine how overheads like the costs of accommodation and human resources have been allocated to these parts of the business so that electricity customers are not cross-subsidising other areas of TransGrid's activities. We would seek to be assured of this in the Final Decision.
- The EUAA does not agree that regulated businesses should be allowed a reduction in performance targets to accommodate degradation in performance due to capital works. The EUAA is of the view that the regulation of monopoly businesses should proxy the outcomes of a competitive market. In a competitive market context a firm could not expect leniency from customers in the event that a capital works program may degrade service or product standards. Accordingly, the EUAA does not agree with the draft decision of the AER to incentivise the imposition of degraded service standards on customers. The EUAA does not agree that the allowance of degradation in service performance targets is consistent with the aim of the service target incentive scheme, i.e. to encourage TNSPs to maintain or improve the quality of service provided to customers.
- The EUAA does not agree with the caps and collars decided in the draft determination on the basis that they are based on a degradation of the service performance targets. Although the EUAA accepts the cap/collar logic applied by the AER in its draft decision, the EUAA recommends that this logic references service targets that are not degraded.

2 INTRODUCTION

The Energy Users Association of Australia (EUAA) welcomes the opportunity to submit the following comments to the Australian Energy Regulator (AER) for its consideration in relation to its final decision on TransGrid's Revenue Proposal 2009/10 to 2013/14.

The EUAA is a non-profit organisation funded by membership fees, internally generated revenue and external funds. It is focused entirely on energy issues and was formed in 1996. Members determine EUAA policy and direction and elect a Board made up of fellow members. The Association's members are business users of energy with activities across all states and many sectors of the economy. The EUAA has over 100 members and this includes most of the largest users in New South Wales and those large users who are directly connected to the TransGrid network.

Whilst the EUAA is pleased that the AER has recognised that TransGrid has significantly over-estimated their revenue requirements and has seen fit to reduce the capex allowance by $173M (real 2008 $), its opex allowance by $83.7M (real 2008 $) and its revenue by about $46.4M (nominal) over the regulatory period, end-users are presently facing multifaceted and significant cost pressures on many fronts. We are therefore very concerned that TransGrid is proposing what in effect is a 32% increase in average TUoS between the current and next five-year regulatory periods. Added to this, the global financial crisis and the consequent economic downturn, including in Australia, would make the proposed increase in TUoS charges particularly ill-timed and unfortunate. Given this concern we have prepared the following comments based on our review of TransGrid's initial and revised revenue proposal, of the AER's draft decision relating to the initial revenue proposal, and of the additional reports and submissions that are part of the consultative process.

3 FORECAST CAPITAL EXPENDITURE

In its initial revenue proposal TransGrid sought a capital expenditure allowance of \$2.550 billion for the forthcoming regulatory period. In response to the AER draft decision that reduced TransGrid's proposed capex allowance by \$173 million to \$2.377 billion, TransGrid also submitted a revised revenue proposal that seeks a capex allowance of \$2.515 billion. This revised capex allowance represents an 80% real increase relative to the expected actual capital expenditure for the current regulatory period.

The EUAA notes that energy users are facing additional pressure due to cost increases on multiple fronts, including rising wholesale electricity prices and gas prices, a carbon price and the impact of the expanded Renewable Energy Target (RET). Should the AER draft decision be implemented, end-users will also experience large real increases in NSW network charges that are particularly badly timed and unfortunate. Added to this are the global financial crisis and the consequent economic downturn, including in Australia and New South Wales. They will almost certainly intensify the problems they are facing with consequences for their competitiveness, operations and investment.

In this context of significant and increasing cost pressures on end-users, including the deteriorating financial consequences that the economic climate is imposing on industry and households, the EUAA questions whether more could have been done to alleviate some of this excessive real increase in requested capex.

The EUAA has concern that expenditure alleviation options, particularly demand management options, have not been fully identified and considered by TransGrid. Moreover, the cost benefit assessment of options in general has been found to be a systemic deficiency within TransGrid's planning approach.

It is the view of the EUAA that the identified and systemic deficiencies in TransGrid's capital expenditure planning methodology and procedures cannot ensure that the resultant capex program reasonably reflects the capex criteria under clause 6A.6.7(c), namely:

- the efficient costs of achieving the capex objectives;
- the costs that a prudent operator in the circumstances of the relevant TNSP would require to achieve the capex objectives; and
- a realistic expectation of the demand forecast and cost inputs required to achieve the capex objectives.

The following sections describe the concerns of the EUAA.

3.1 Cost-benefit assessment of investment options

TransGrid's initial forecast capex program consisted of over 160 projects that may take place during the next regulatory control period. The projects featured in TransGrid's capex program included augmentation, replacement, easement and, security and compliance projects.

The AER engaged PB to undertake a detailed review of a sample of projects from TransGrid's capex proposal to ensure that it is in accordance with the requirements of clause 6A.6.7 of the NER. PB reviewed 11 capex projects with a total value of $1.04 billion.

As a result of PB's findings, and the AER's consideration of these findings, a systemic weakness in TransGrid's project evaluation approach has been identified.

The following extracts from the AER draft decision paper describe this deficiency:

"Overall, while PB's detailed review of TransGrid's initial capex proposal found it to be generally reasonable in terms of prudence and efficiency it did find systemic issues, where there was scope for improvement. In particular, PB found issues with TransGrid's

- *application of scoping and cost factors which lacked transparency*
- *options analysis, which was inadequate." [p.47]*

"With reference to TransGrid's option analysis, PB considered it:

- *failed to include all relevant information and sensitivity analysis was not used to inform the options choice*
- *did not rely on the results of the options analysis, but tended to rely on qualitative arguments to dismiss the findings of the economic options analysis to justify its preferred option. " [p.48]*

"The AER also notes that TransGrid's capex estimating database manual allows for the standard factors to be altered if the project investigation identifies that the standard factors are not appropriate. As the weight of each factor can be adjusted on a discretionary basis for particular projects the capital estimation process can lack transparency, consistency and auditability. The AER therefore considers TransGrid's process for adjusting standard factors creates an environment where the scope for systemic overestimation of proposed capex project costs is present." [p.61]

"The AER agrees with PB's finding that in many cases TransGrid has relied on engineering judgement, which has not been transparently applied, to select a particular project option which would not be the preferred option on economic grounds." [p.48]

"Furthermore, the AER considers that the NPV assessments underlying several investment decisions have not been complete and often omitted certain costs and benefits." [p.48]

"The AER also notes that judgement has been applied in the scoping and costing of several projects, and in the development of TransGrid's risk allowance." [p.48]

"The AER considers that TransGrid has scope to improve its analysis of potential investments with regards to:

- *including all quantifiable costs and benefits in NPV analyses*
- *subjecting investment decisions to sensitivity analysis where options are closely ranked or are based on uncertain parameters*
- *properly documenting the basis for decisions (including the dismissal of alternative investment options and changes in project costs) that are based on judgement, with reference to credible evidence where possible."[p.49]*

"PB's detailed review of a representative sample of TransGrid's proposed forecast capex projects identified a number of issues that it considered may be prevalent across the entire proposed forecast capex allowance. These issues include the:

- *inadequate or non-consideration of likely reasonable options within NPV analysis*
- *discretionary adjustments to unit cost benchmarks to account for project specific matters."[p.60]*

It is the view of the EUAA that these issues are sufficiently serious, particularly the findings by PB that these issues are systemic, that economically preferable options have been dismissed on the basis of engineering judgement, that capex costs may be systemically overestimated, and that evaluation processes lacks auditability, such that a general finding of prudency and efficiency cannot be made. Given the context of an 80% real increase in the requested capex allowance, to $2.515 billion, these findings should not be dismissed; nor should there be an assumption that these findings are minor.

TransGrid's revised revenue proposal does not remedy these concerns.

The EUAA recommends the AER request from TransGrid detailed cost-benefit assessments, including an assessment of project deferral and demand management options, and capex-opex trade-off options, for each of the proposed initiatives in its capex program. The EUAA also requests that TransGrid be asked to explicitly show how its comprehensive DMPP database of demand management opportunities was used in the evaluation of each capex project.

The following is an extract from TransGrid's Revenue Proposal (May 2008):

"As a significant example of demand management planning, TransGrid has been working with Energy Australia on the Demand Management and Planning Project (DMPP) with

the objective of slowing the growth in demand, and thus deferring or avoiding network expansion, in Sydney. Initiatives to gather information on opportunities for reducing demand have been instigated at more than 700 sites in St George/Sutherland, Sydney CBD, North Sydney, the Inner West and East Sydney.

The project, to be completed by June 2008, has produced a comprehensive database of opportunities for the reduction of peak demand.

TransGrid intends to continue this work with Energy Australia in the expectation of implementing initiatives that may defer capital works in the Sydney Metropolitan area. TransGrid also plans to cooperate in this way with the other NSW distributors, Integral Energy and Country Energy. " [p.31]

The EUAA seeks greater transparency in the assumptions, options, trade-offs and decisions that are made in the process of investment planning.

3.2 Demand forecasts

The EUAA is pleased that TransGrid has updated its revenue proposal to accommodate the 2008 APR which was not available at the time when its initial 31 May 2008 Revenue Proposal was prepared.

Despite these efforts to accommodate the annual update in the demand forecast, the EUAA notes that the economy is experiencing a significant deterioration with unprecedented rapidity.

The EUAA notes that significant instability in international financial markets, and falls in economic growth associated with the failure of numerous major financial institutions and general weakness in global markets, occurred largely subsequent to the release of TransGrid's 2008 APR. Moreover, the pace at which the economy is deteriorating is increasing, and is continuing to surprise economic commentators and policy-makers. Recent observations suggest that the world is moving into a period of synchronised down-turn across most significant economies.

The EUAA suspects that the 2008 APR may now over-estimate the demand for electricity in NSW, thereby questioning whether TransGrid's proposed capex program is based on a realistic expectation of the demand forecast and of other associated cost parameters.

While the 2008 APR relied on economic growth projections made by the NIEIR, and while these projections did assume an uncertain economic outlook, the EUAA observes that this outlook is now one year old, and unlikely to be realistic or sufficiently reasonable. The unprecedented and extreme shifts in Australia's monetary and fiscal policy during the past year is evidence of a dramatic and severe change in economic fundamentals. The EUAA therefore does not agree that the demand basis for the capex program is likely to be consistent with the requirements of the capex criteria of the NER and believes there is strong evidence that it needs to be revised downwards, as would the capex program.

The EUAA urges the AER to seek analysis that considers the current reasonableness of the 2008 APR as the basis for determining a five-year capex program.

3.3 Investment uncertainty and TransGrid's planning assumptions

The EUAA observes an unprecedented level of uncertainty that presents considerable risk to any large capital expenditure program. This uncertainty is multifaceted, driven by an extreme change in the real economy, a near collapse of the international financial system, and an evolving energy policy that will comprehensively transform the energy industry.

In particular, the impact of the Carbon Pollution Reduction Scheme (CPRS)/expanded RET may shift centres of generation from coal regions to regions near gas infrastructure and renewable energy resources. This may present transitional difficulties given that traditional planning assumptions may not best facilitate a geographic shift in the location of bulk transmission assets; the assumption of incremental growth in favour of regions with thermal plant may no longer be relevant. New transmission planning paradigms may be required, and the traditional pattern and direction of investments may become redundant.

It is for these reasons that the EUAA cautions against a large capex program that is largely supply driven and operating within the current paradigm, and favours a closer look at demand management/distributed generation initiatives that may defer the need for physical investments, thereby providing time for these uncertainties to sufficiently resolve.

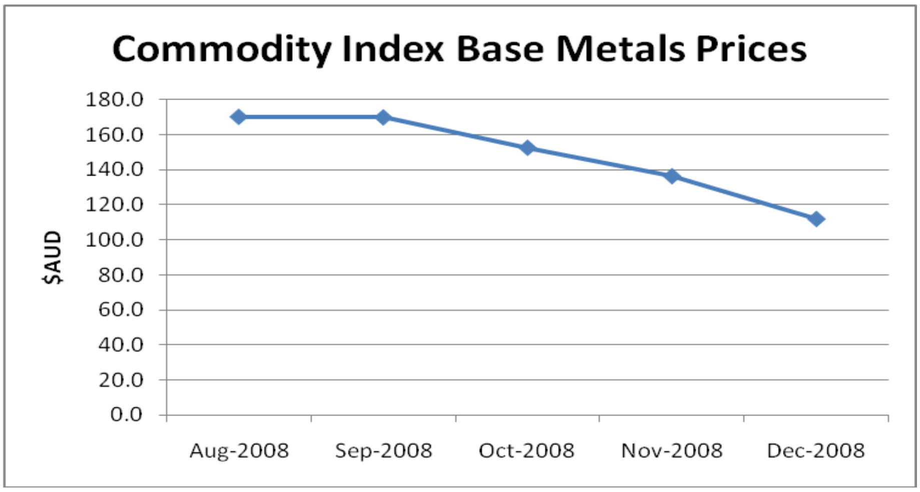
The EUAA therefore reiterates its suggestion, particularly in light of PB's findings of a systemic failure in TransGrid's option evaluation approach, that TransGrid be requested to explicitly demonstrate the demand management initiatives that it identified and dismissed in its evaluation of each capex project that comprises its $2.515 billion dollar request. These uncertainties are unprecedented in their extent, so the EUAA recommends that investment deferral options become a major consideration in the determination of TransGrid's capex allowance.

3.4 Cost accumulation processes

The real economy is moving into a synchronised global down-turn that is causing many cost factors relevant to the TransGrid revenue proposal to significantly decline.

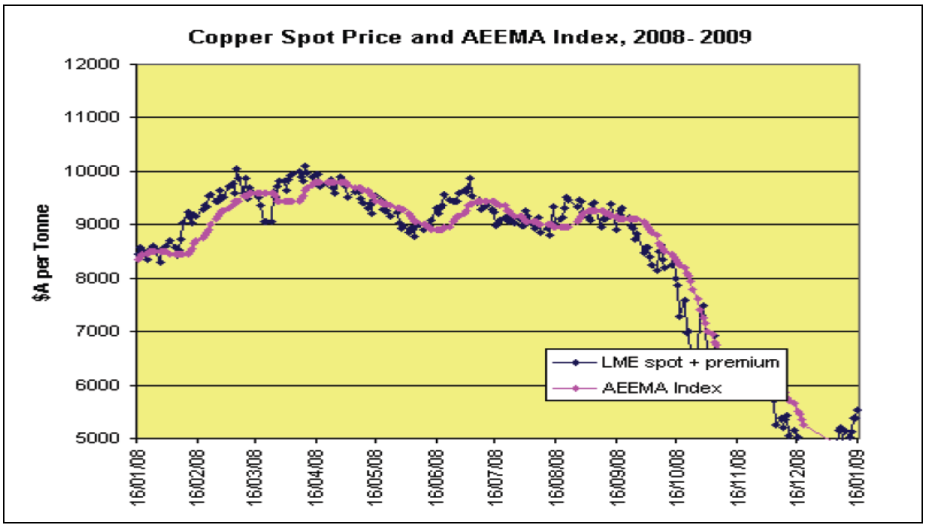
The current global economic woes have seen falls in materials costs domestically and globally. The Reserve Bank of Australia's Index of Commodity Prices shows a decrease in commodity prices of 4% in December 2008. [1]

Chart 1: RBA Commodity Index for Base Metals Prices



The above chart demonstrates the falls in base metals prices since August of 2008. Reserve Bank of Australia data shows that base metals prices have declined from a high of $A170 per tonne to around $A110 per tonne in December of 2008.

Chart 2: Copper Spot Prices Jan 2008-Jan 2009[2]



The above chart shows the falling copper spot prices and the Australian Electrical and Electronic Manufacturer's Association (AEEMA) copper prices index. This index shows substantial falls in copper spot prices from $A9000 per tonne in August-September 2008 to just over $A5000 per tonne in mid to late 2008.

[1] Reserve Bank of Australia '*Monthly Statistical Release*' Index of Commodity Prices 2 Feb 2009
[2]Olex Cables Australia www.olex.com.au/Miscellaneous/Copper-Price.htm.

The EUAA does not agree with the AER implication on page 68 of its draft decision paper that capex cost escalators should account for the past commodity boom and skilled labour shortages as these conditions are no longer realistic as an assumption for the duration of the next regulatory period. It is not acceptable to end users that they are required to pay for an out-of-date cost accumulation process and nor should it be to the regulator. The AER indicated at the pre-determination conference that it would be reviewing the cost escalators and we welcome this undertaking.

The EUAA recommends that base unit costs, cost deflator assumptions, cost escalation factors and labour costs be reviewed and updated for the changed economic circumstances that have resulted in the past 12 months since TransGrid's capex planning assumptions were developed. This should occur prior to the final revenue determination.

3.5 Contingent projects

TransGrid proposed that 18 projects with a total indicative cost of $2.3 billion be included as contingent projects in its initial revenue determination. This increased to 19 projects following the release of the 2008 APR. The AER draft decision found that nine of these projects do not meet the requirements of section 6A.8.1 of the NER. TransGrid, in its revised revenue proposal (January 2009) has since resubmitted six of these disallowed projects with updated information. In its draft decision, the AER supports a contingent allowance of $1.2 billion.

Again, the EUAA reiterates PB/AER findings regarding TransGrid's systemic weaknesses in its planning process; specifically:

- that economically preferable options have been dismissed on the basis of engineering judgement;
- that capex costs may be systemically overestimated;
- that evaluation processes lack auditability;
- inadequate or non-consideration of likely reasonable options within NPV analysis; and
- that the NPV assessments underlying several investment decisions have not been complete and often omitted certain costs and benefits. [p.48]

Accordingly, the EUAA recommends that AER requests from TransGrid detailed cost-benefit assessments, including an assessment of project deferral and demand management options, and capex-opex trade-off options, for each of the proposed contingent initiatives in its capex program. The EUAA also requests that TransGrid be asked to explicitly show how its comprehensive DMPP database of demand management opportunities was used in the evaluation of each contingent project.

4 COST OF CAPITAL

The EUAA recognises that in order to maintain stability in service standards and minimum prices in the long run, the return provided to a TNSP should provide for an efficient level of investment over time, ensuring a correct balance between capital maintenance and renewal in a broader context that encourages non-network solutions to support growth and service quality bearing in mind the low risk position of TNSPs.

Chapter 6A of the NER, v21, prescribes the method and values for most of the parameters to be used in calculating the Weighted Average Cost of Capital (WACC) and taxation in a TNSP's revenue proposal. The setting of these parameters are the result of a consultative and iterative process that now provides the market with a degree of certainty affecting the method for setting regulated revenue, therefore reducing investment risk, and the effect this has on the timing and scope of investment decisions, and ultimately end-user prices.

4.1 Nominal risk free rate, the debt risk premium and expected inflation

Two of the major parameters in the WACC that are determined as part of a TNSP's revenue determination are the nominal risk free rate and the debt risk premium. While not an explicit parameter in WACC calculations, expected inflation is an input in the post-tax revenue model to forecast nominal allowed revenues.

The NER prescribe the method for determining the nominal risk free rate. This method provides the AER with discretion in determining the period of time from which, on a moving average basis, the risk free rate is calculated using 10 year government bonds. The Debt Risk Premium is then determined by calculating the premium between the annualised nominal risk free rate and the observed annualised benchmark corporate bond rate which meet the prescribed credit rating and maturity requirements.

The Reserve Bank of Australia has been pursuing an aggressive cycle of monetary easing, with large reductions in the cash rate having occurred in the last six months, and significant further reductions could be announced over the next few months. Large and repeated cuts in the cash rate are causing repeated falls in yield curves, and therefore the yield on medium to long term Commonwealth and Australian corporate bonds, which is relevant in the AER's WACC determination. Accompanying this shift in monetary policy is an implied easing of inflationary expectations, in part caused by the dramatic down-turn in demand, and also significant falls in the price of goods and services, including many that are relevant to TransGrid's revenue determination.

We reiterate our previous recommendation that the averaging period used to calculate the risk-free rate and debt risk premium should appropriately reflect the current credit crisis and global slow-down, including the current process of monetary easing which is expected to continue over the next few months. The EUAA recommends that the averaging period should reflect the latest iteration of monetary policy that is current at the time the final revenue decision is published.

The EUAA also agrees with the AER's approach to use the latest RBA statement on monetary policy at the time close to its final determination of allowed revenue to support the process for deriving an inflation forecast for use in the PTRM.

4.2 AER review of WACC parameters

We note that the AER is presently conducting a review of WACC parameter values, methods and credit rating levels that are to apply to transmission determinations where the revenue proposal is submitted to the AER between 31 March 2009 and 1 April 2014 in accordance with clauses 6A.6.2 and 6A.6.4 of the NER. This review will determine new WACC parameter values, methods and credit rating levels that will supersede the equivalent values, methods and credit levels prescribed in clauses 6A.6.2 and 6A.6.4 of version 22 of the NER (dated 23 October 2008).

The AER has determined that the revised parameter values, methods and credit rating levels from this review will not apply to the TransGrid revenue determination given that the initial revenue proposal was submitted prior to 31 March 2009.

Given that the timing of the TransGrid revenue reset and the WACC parameter review are closely aligned, the EUAA is of the view that a failure to apply new WACC parameters to TransGrid will make the parameters applied out-of-date, producing an outcome that could distort efficient pricing and investment. Indeed, the AER has presented strong evidence that at least two of the existing parameters, the equity beta and gamma, are badly out-of date. In the case of the equity beta, the AER recommended a reduction in the parameter from 1.0 to 0.8, despite justifying this reduction with evidence supporting even lower estimates between 0.44 and 0.68[3].

Unfortunately, the AER's position is likely to force end users to pay higher transmission charges to TransGrid for another five years. Given the concerns we expressed earlier in this submission about the formidable and multifaceted costs pressures facing energy users in the next five years, this is a most unfortunate decision for the AER to have taken.

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[3] See the AER Explanatory Statement- Electricity transmission and distribution network service providers Review of the weighted average cost of capital (WACC) parameters; December 2008; p252
http://www.aer.gov.au/content/item.phtml?itemId=724642&nodeId=dc61681b46489076b1fd720cc10af39e&fn=Explanatory%20statement%20(11%20December%202008).pdf

The EUAA also submitted a Rule Change Proposal to the AEMC seeking to have two of the key WACC parameters at issue, the equity beta and gamma, whose values are embedded in the NER, changed to values that better reflect their true value. This included a proposal to apply the new parameters to this review. Unfortunately, the AEMC rejected the proposal and deferred to the AER WACC review. The Rule Change Proposal is supported by evidence and argument compiled by an acknowledged expert in this field, Associate Professor Martin Lally of the Wellington University.

5 FORECAST OPERATING EXPENDITURE

In its initial revenue proposal TransGrid sought an operating expenditure allowance of $848.5 million for the forthcoming regulatory period, including an allowance for controllable operating costs of $757.6 million. The AER draft decision reduced TransGrid's proposed opex allowance by $83.7 million to $764.8 million. TransGrid submitted a revised revenue proposal that seeks an opex allowance of $809.6 million. In this current regulatory period, TransGrid's expected actual opex expenditure is $634.6 million (real 2008 $).

5.1 Labour cost and asset growth escalations

The EUAA does not accept that the next regulatory control period will be characterised by a tight labour market that will cause real wages to significantly increase as submitted by TransGrid in its original proposal and supported by the AER's draft determination. The current volatile economic environment that has caused unprecedented and extreme monetary and fiscal policy measures to support employment in Australia is suggestive of a weak labour market.

The EUAA requests that in light of the recent economic collapse, and the synchronised global down turn, that the AER refresh its labour cost escalation assumptions.

Further, it is not clear from TransGrid's revenue proposal, or from the AER's draft decision, what labour productivity savings have been assumed, and to what extent these feature in the expenditure forecasts. Expected real wage increases should be ultimately discounted for normal increases in labour productivity.

The EUAA agrees with the AER in its decision that the use of CPI as an escalator for the non–labour component of TransGrid's opex reflects the efficient costs that a prudent operator in the circumstances of TransGrid would require to achieve the opex objectives, as required by clause 6A.6.6(c).

The EUAA agrees with the AER that the defect maintenance forecast proposed by TransGrid is not reasonable because it does not factor in the significant increase in new assets proposed to be commissioned during the next regulatory control period. The EUAA agrees with the adjustment proposed by PB to remove the defect maintenance costs for those assets which are commissioned during the next regulatory control period.

5.2 Demand management allowance

TransGrid has proposed an allowance of $1 million per annum ($2007–08) to develop and investigate demand side management responses to emerging constraints in the transmission system.

TransGrid submitted that its proposed demand management allowance would allow it to better understand and give consideration to non-network alternatives, and to meet new obligations under the regulatory test that require TNSPs to consider non-network alternatives.

TransGrid stated that it has been working with EnergyAustralia on the Demand Management and Planning Project (DMPP), which was established by the NSW Department of Planning in March 2002, and completed in June 2008. The objective of the DMPP was to identify potential opportunities to reduce consumer peak demand for electricity in the inner Sydney region. The DMPP gathered information on opportunities for reducing demand at more than 700 sites in the Sydney CBD and inner suburbs.

The EUAA welcomes TransGrid's planned demand side management initiatives. The EUAA also welcomes TranGrid's initiative in use of demand management to defer a major upgrade to the Newcastle-Sydney-Wollongong loop, which highlights that DM can be effective if properly applied. However, we note that this is being paid for by end users as higher TUoS charges due to a pass through decision by the AER, whereas TransGrid was already being compensated for this deferral via reduced capex.

Our comments on TransGrid's initial revenue proposal recommended that the DMPP should be reviewed to quantify the benefits received, particularly given TransGrid's proposed huge capex requirements for the next regulatory control period. It is not clear that this has occurred; indeed, in its draft decision the AER states:

> *"To assist the AER's understanding of the outcomes TransGrid is seeking to achieve from the proposed demand management incentive allowance and to provide increased transparency and accountability, the AER will request information from TransGrid on how the allowance was spent, and on the outcomes of the initiatives implemented during each year of the next regulatory control period."[p.116]*

While this ex-post assessment is desirable, the EUAA has some concern that the DMPP has achieved very little return for the money invested. TransGrid has not demonstrated that its planning process has utilised the projects identified by its review of 700 sites in its DMPP database to identify any initiatives that could offset or delay significant expenditure projects over the next five years.

The EUAA recommends that the AER investigate the outcomes of the DMPP program and whether these potential initiatives were fully represented and assessed as part of TransGrid's expenditure planning process for this revenue reset. The EUAA recognises that demand management initiatives have the potential to delay or avoid high cost alternative investments in physical assets, and that advice of these savings would benefit a revenue proposal, particularly in demonstrating prudence and efficiency in decision making. To the extent that no savings have been identified by TransGrid in

its proposal, or revealed via PB's investigations, one may assume that they may not exist. The EUAA therefore questions whether customers are likely to achieve any return for providing TransGrid with this allowance unless a clear benefit can be established.

5.3 Network Support

The EUAA has major concerns with pass through provisions related to network support events; specifically:

- There is an apparent asymmetry of information and process. Customers are not provided sufficient and ongoing information to know if an event occurred that would allow a pass through of reduced costs. Are customers allowed to apply when there are lower costs? What incentives do TNSPs have to make such applications?

- In the past, regulatory provisions and rules related to pass-through events have at times been inadequate, providing for the pass-through of costs that had in part already been given;

- Pass-through provisions effectively allow TNSPs to transfer risk to customers; this transferral of risk is not matched by a commensurate ability to manage it, nor is it consistent with what would be expected in a competitive industry.

EUAA members have expressed their concerns that pass-through decisions in the past have resulted in price increases of up to 30%, an extent of increase that is difficult to manage, and which at times has related to expenditure in other parts of the system, and therefore which is not locationally commensurate with an improvement in service levels.

Having reviewed the AER draft decision, the EUAA observes that:

- the AER has accepted a forecast allowance of $45.5 million for network support payments;

- the AER considers that that there is some uncertainty around the timing and amount of these payments; and [p. 132]

- The AER notes PB's advice that the cost of network support payments cannot be estimated to the same degree of accuracy as other costs such as construction works or maintenance programs because network support services are provided by external parties on an opportunistic basis. [p. 132]

While it is acknowledged that, in the event of an overspend or underspend, a TNSP must seek a determination by the AER for a variation in a network support pass through amount to customers, the EUAA has concern that regulated businesses, such as TransGrid, will have little if any incentive to draw such matters to the attention of the regulator and end users are not in a well informed enough position identify and act on any underspend events

We therefore recommend that the AER takes steps to mandate the provision of information by regulated businesses to improve transparency in these situations.

5.4 Non-regulated activities

It is not clear from the draft decision to what extent non-regulated activities have been investigated, and to what extent these may overlap with costs that feature in the regulated components of the revenue proposal.

The EUAA understands from the PB report that TransGrid's non-regulated activities include the connection of new generators and new customers to its network, and that these costs are recovered through negotiated and non-regulated transmission services. PB states that revenue and costs derived from these services have not been included in the revenue proposal.

The AER should examine how overheads like the costs of accommodation and human resources have been allocated to these parts of the business so that electricity customers are not cross-subsidising other areas of TransGrid's activities. We would seek to be assured of this in the Final Decision.

5.5 Self insurance

The EUAA is satisfied with the draft decision of the AER in relation to the self insurance allowance.

6 SERVICE STANDARDS

The AER's service target performance incentive scheme (the scheme) aims to encourage TNSPs to maintain or improve the quality of service provided to customers.

Under a revenue cap regime, TNSPs can increase their profits for regulated activities by reducing their operating costs. Such cost reductions could result from efficiency gains or by allowing service levels to decline. The latter imposes costs on other market participants.

Performance targets, caps and collars

As a matter of principle, the EUAA does not agree that regulated businesses should be allowed a reduction in performance targets to accommodate degradation in performance due to capital works. The EUAA is of the view that the regulation of monopoly businesses should proxy the outcomes of a competitive market. In a competitive market context a firm could not expect leniency from customers in the event that a capital works program may degrade service or product standards.

Accordingly, the EUAA does not agree with the draft decision of the AER to incentivise the imposition of degraded service standards on customers. The EUAA does not agree that the allowance of degradation in service performance targets is consistent with the aim of the service target incentive scheme, i.e. to encourage TNSPs to maintain or improve the quality of service provided to customers.

The EUAA recognises that TransGrid is seeking a massive 88% increase in its capex allowance; the EUAA does not consider that service quality should be sacrificed to ensure program deliverability, particularly when demand management initiatives are available to smooth deliverability issues in a manner that can maintain or even improve service quality.

The cap and collar for each parameter define the range of performance within which TransGrid will receive a financial reward or penalty. The cap and collar also determine the rate at which TransGrid will receive a bonus or penalty based on its annual performance. The cap is the performance value that results in the maximum financial reward for any one parameter and the collar is the performance value that results in the maximum financial penalty.

The EUAA does not agree with the caps and collars decided in the draft determination on the basis that they are based on a degradation of the service performance targets. Although the EUAA accepts the cap/collar logic applied by the AER in its draft decision, the EUAA recommends that this logic references service targets that are not degraded.

Market impact parameter

TransGrid's market impact parameter is the number of five-minute dispatch intervals where an outage on TransGrid's network results in a network outage constraint with a marginal value greater than $10/MWh, for a calendar year.

There is no penalty if the performance target is not met.

Although the EUAA accepts the draft decision of the AER, we reiterate our previously stated preference that the market impact logic becomes a two way scheme of financial rewards and penalties, and urges the AER to consider options for a penalty scheme to be introduced in the future.