6 February 2015

Mr Chris Pattas
General Manager
Network Investment and Pricing
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: TransGridrevenuereset@aer.gov.au

Submission to Transgrid response to draft determination (2014 to 2019)

Thank you for the opportunity to provide the Energy User Association of Australia's (EUAA) perspectives on Transgrid's response to the AER's draft determination.

The key business metric of after tax profit is drawn from Transgrid's annual reports and is shown in this submission to be in excess of $200,000,000 in 2013-14 at an equivalent return on equity in the order of 10%.

This outcome and future outcomes of this nature (if left unchecked by the AER) in the forthcoming regulatory period is (and will be) the direct result of increased network charges paid by consumers and an unsustainable burden on EUAA members' businesses.

We seek AER's careful consideration of equitable outcomes for consumers without what we would consider a distorted distribution of dividends back into the networks.

The EUAA is encouraged by the approach that the AER has taken in the consideration of the network business's draft determinations and in particular its use of benchmarking data, albeit still a work in progress. We humbly submit that the AER remain firm in the face of strident opposition as the arguments put forward by the networks to grow their RAB comes at the cost of consumers and users struggling to cope with escalating electricity costs.

We hope you find the enclosed EUAA response of assistance to the AER's determination process and welcome further dialogue or clarification on any of the matters raised.

Please do not hesitate to contact me should you require any clarifications or further information regarding this submission.

Yours sincerely

Philip Barresi
Chief Executive Officer
Energy Users Association of Australia (EUAA)

SUBMISSION TO THE AER

EUAA RESPONSE TO AER DRAFT DETERMINATION AND TRANSGRID REVISED REVENUE PROPOSAL 2014 – 2019

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1 EXECUTIVE SUMMARY

The EUAA is pleased to see that the Better Regulation Reforms appear to be having some positive outcomes for customers via its first round of draft determinations in NSW and Tasmania.

The EUAA supports the general direction the AER has taken in the draft determination for Transgrid. However, as discussed further in this submission, the EUAA are of the view that there is argument for further reductions to the AER draft determination in the key areas of WACC, capex and opex[1].

To illustrate this, putting aside augmentation in capex, there is only a 7% real reduction compared to the previous period and a 4% real increase in total opex allowance.

The EUAA believes that despite some imperfections, benchmarking should have been more influential as the time is right to take a bigger picture view. In simple terms, the demand for electricity networks services particularly Transgrid's is flat and the logical corollary is that Transgrid's regulated business should not be growing.

Many network owners (with the notable exception of Transend) do not appear to be taking that bigger picture perspective as demonstrated by the position taken by Transgrid in its revised proposal being only marginally below their original proposal.

In summary, the EUAA are of the view:

- The RAB should not be growing given maximum demand is not likely to return to historic levels until 2022-23[2].
- Operating costs should not be increasing in real terms. In fact there should be real cost reductions reflecting an aggressive pursuit of efficiency.
- Return on capital should reflect the returns of real world businesses taking into consideration the very low risk of network businesses under the current NER.
- Transgrid have not made a compelling case in regard of their proposed allowance achieving the NEO. In particular it has not distinguished mandatory expenditure required to meet TNSP licence conditions vs. discretionary expenditure which is more related to risk of meeting Transgrid's obligations.
- Escalating after tax profit of over $200,000,000 in 2013-14 (see Figure 10) and return on equity of 10% is the direct result of increased network charges paid by consumers.

The EUAA recommends the following based on the AER draft determination and Transgrid's revised proposal.

Recommendation 1

The AER exercise its full discretion to consider market information, further benchmarking and research on Australian business investment returns considering the low risk profile of network businesses and use this to influence its rate of return final decision.

Recommendation 2

Based on Transgrid's medium and low 10% POE demand growth scenario and an objective to maintain total investment proportional to the demand, the AER consider the merits of further reduction in the total capex allowance to a range between $574M - $794M and allow Transgrid to prioritise projects within that allowance.

Recommendation 3

The AER approves a total opex allowance reflecting efficiency of no more than $600M in $2013-14 and that the benefits are returned to customers immediately.

[1] All costs and comparisons included in this submission are in $2013-14 unless indicated otherwise.

[2] AEMO 2014 National Electricity Forecast Report

2 Overview comparison of key maximum allowed revenue (MAR) elements

The following table summarises key elements of the Maximum Allowed Revenue (MAR) on a comparative basis. It demonstrates the differences between Transgrid, the AER and EUAA proposal.

Table 1 : Overview Comparison of key MAR Components[3]

	2009-14 period (pro rated for 4 years)	TG RP (revenue proposal)	AER DD (draft determination)	TG RRP (revised revenue proposal)	EUAA Proposal
WACC					
Value	10.05%	8.83%	7.24%	8.65%	< 6%
% change from 2009-14	n/a	-12.1%	-27.9%	-13.9%	> -40%
% change from TG RP	n/a	n/a	-18%	0%[1]	> - 30%
TOTAL CAPEX					
Value	$1,805M	$1,388M	$922M	$1,346M	$574M to $794M
% change from 2009-14	n/a	-23%	-41%	-25%	-68% to -56%
% change from TG RP	n/a	n/a	-34%	-3%	-57% to -41%
TOTAL CAPEX (excl Augex)					
Value	$916M	$1,315M	$850M	$1,272M	n/a [3]
% change from 2009-14	n/a	+44%	-7%	+39%	
% change from TG RP	n/a	n/a	-35%	-3%	
TOTAL OPEX[2]					
Value	$633M	$785M	$660M	$746M	< $600M
% change from 2009-14	n/a	+24%	+4%	+18%	- 5%
% change from TG RP	n/a	n/a	-16%	-5%	-20%
CLOSING RAB ($M nom)					
Closing Value 2013-14	n/a	$6,147M	$6,147M	$6,076M	
Closing Value 2017-18	n/a	$7,227M	$6,697M	$7,114M	< $6,470M
% change in RAB from 2009-14		+18%	+9%	+17%	< + 6.5%

[1] This is effectively the same because the methodology is the same as the Transgrid original revenue proposal it is just updated for changes in risk free rates.

[2] Includes debt raising costs

[3] EUAA would agree for Transgrid to manage their portfolio under a total capex allowance.

[3]Based on Transgrid revenue proposals, RIN data and the AER draft determination

3 WACC – the AER needs to factor in real world considerations

The EUAA believe the nominal vanilla weighted average cost of capital (WACC) of 7.24% is too high and does not reflect return vs risk of the real business world. The EUAA reinforces the message contained in its Ergon and Energex submissions on WACC regarding taking a more practical approach rather than the highly theoretical current approach with Professor A vs Professor B.

The EUAA respectfully suggests that the AER research some data sets of industries that are customers of monopoly service providers and make an assessment of their risk versus return.

The EUAA fully support the messages outlined in the Consumer Challenge Panel paper to the AER dated July 2014 *"Smelling the roses and escaping the rabbit holes: the value of looking at actual outcomes in deciding WACC."*

The EUAA are of the view that the AER should take an outcome approach as the current "bottom up" method of assessing each of the WACC parameters is likely to lead to a less efficient outcome – like the AER have recognised in its assessment of opex and capex. The EUAA also have an expectation that the current Rate of Return Guidelines have ranges that can be fully utilised (ie not just the top end such as equity beta of 0.7).

We understand that if the lower end of the AER ranges were selected a nominal vanilla WACC of around 6% would result.

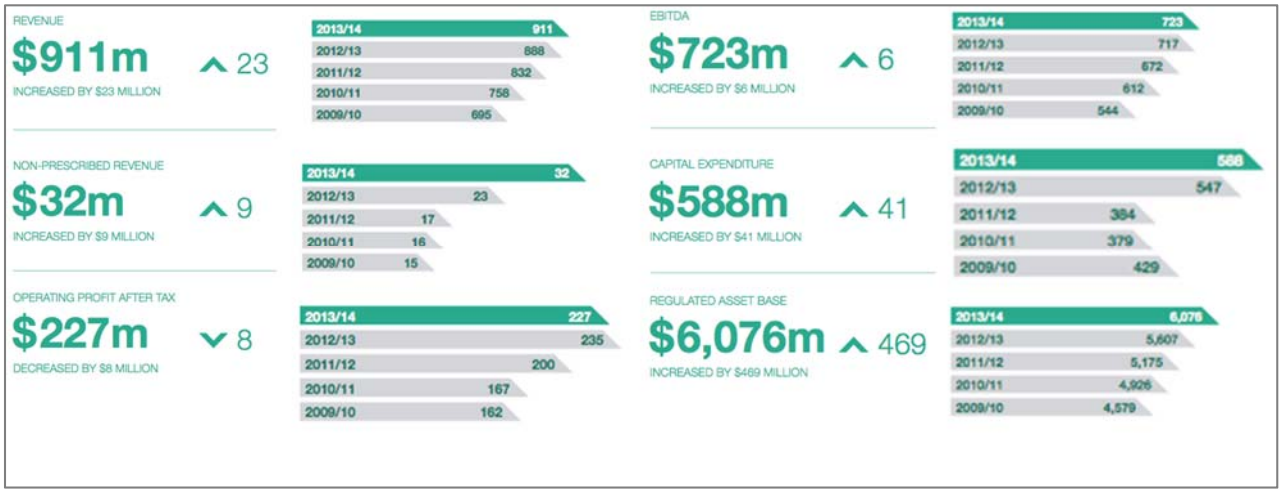
Recommendation 1

The AER exercise its full discretion to consider market information, further benchmarking and research on Australian business investment returns considering the low risk profile of network businesses and use this to influence its rate of return final decision.

4 Capital expenditure - Can be further reduced

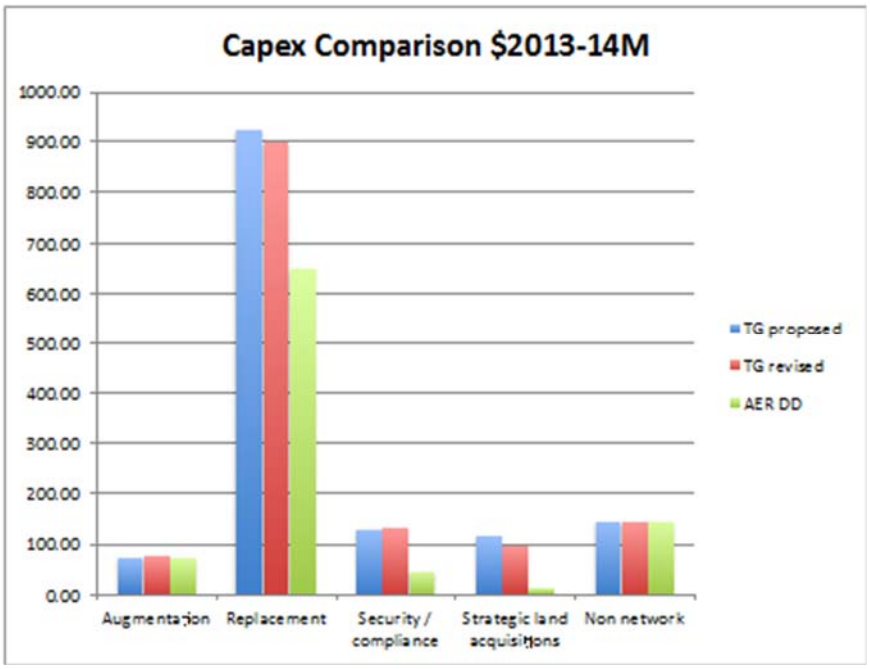
Transgrid has not materially changed their position on capex. It is noted that profits are directly linked to the RAB and growing the RAB is done by maximising capex. This appears to be a unique feature of the regulated monopoly as in a competitive market RAB is irrelevant. In fact the opposite tends to be true, as if you have over invested you are less competitive / profitable and may be out of business. The value of the RAB features on the financial page of Transgrid's Annual Report.

Figure 1 :Transgrid 2014 Annual Report Financial Highlights



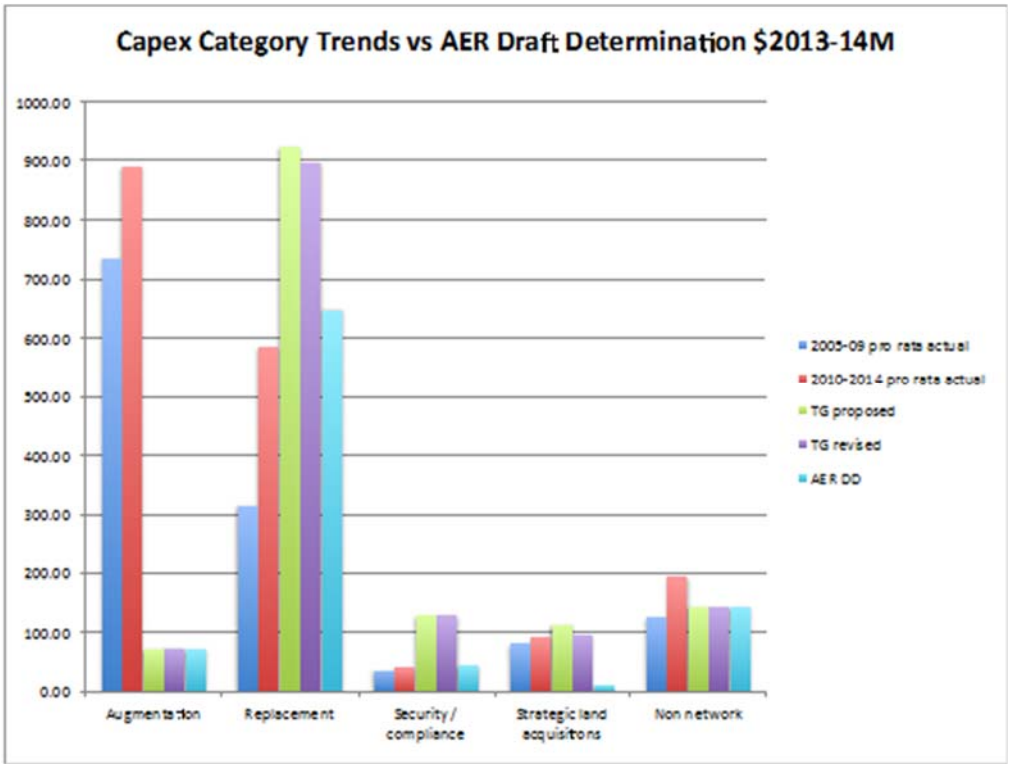
The following graph compares the capex categories between Transgrid's original and revised proposal and the AER draft determination.

Figure 2: Comparison of Capex Categories between Transgrid proposals and AER draft determination



The following graph compares the capex categories across regulatory periods on a like for like basis (correcting for 5 year periods and 4 year periods).

Figure 3: Capex categories across regulatory periods[4]



[4] Based on Transgrid revenue proposals, RIN data and AER draft determination

Observations of the above:

- AER draft determination for replacement is actually an 11% increase on the equivalent 2010-2014 period
- Significant period on period equivalent increases in replacement are 86% and revised proposal 53%. (Note Transgrid overspent its forecast replacement approved by the AER during the 2010-2014 period by approximately 26%)
- AER DD for security and compliance is actually a 12% increase on the equivalent previous period compared to Transgrid's proposed 218% increase in security and compliance
- Augmentation is low reflecting the low demand growth and requirement to pass the RIT-T.
- Transgrid is proposing to maintain historical levels of strategic land acquisitions when forecast demand is flat for foreseeable future.

Transgrid's response to the AER draft determination at the public forum and in their revised proposal suggest that it is the AER's responsibility to have due regard to safety and reliability not just cost.

The EUAA believe that it is the responsibility of Transgrid to clearly demonstrate mandatory expenditure that otherwise would result in a non-compliance to Transgrid's TNSP licence. The remaining expenditure is discretionary and should be based on a solid business case. It seems that Transgrid have been unable to convince the AER.

The EUAA feel that Transgrid seems to be challenging critics of their capex to review every project / argue which ones to exclude which is not in the remit or resource capability of the AER. The EUAA have not had access, (nor would have the resources) to explore the inner workings of the development of Transgrid's capex plan or review each of the 700+ proposed capex projects.

It is unclear of the quantum of the capex is discretionary. However, the EUAA are of the view that the vast majority of capex falls into the discretionary category unless Transgrid can demonstrate otherwise.

It appears that the fundamental issue centres around risk management and how it is applied. In particular:

- Credible interpretation and relationship between asset condition and likelihood of failure
- Credible interpretation of failure consequence – ie direct effect on safety, reliability, cost, licence non compliance, etc
- Risk threshold of Transgrid Board and management compared to similar businesses
- Least cost risk mitigation

Transgrid like other NSP's have significant capacity within their discretionary expenditure resources to prioritise expenditure. The EUAA believe there is very little incentive for NSP's to take on risk and are concerned that network owners may have a mindset that their WACC justifies a particular risk position that is likely to be very conservative. In the absence of competition, why wouldn't you take this position?

Transgrid have provided some top down analysis on page 48 to 51 of their revised proposal centred around replacement as a percent of RAB and arguing long term sustainable levels based on average asset life as well as asset risk profile.

The EUAA make the following comments about this approach.

- What is the risk scale used by Transgrid calibrated against? Maybe Transgrid risk thresholds are far lower than their peers or best practice.
- Is Transgrid's RAB higher than others on a like for like basis?
- Transgrid seem to have been caught in their own argument (page 45) by using RAB and average replacement spend regarding conditions by which they argue don't allow historical values to be used.
- Transgrid's approach will tend to give a high replacement answer as it ignores a significant feature of the NER in regard to forward investment planning horizons being limited to between 10 to 15 years and augmentation. Many assets may be "replaced" by virtue of augmentation ahead of "end of life".

The EUAA believes all Network Service Providers (NSP's) need to be more commercial and outcome focussed by demonstrating real restraint in managing the growth in RAB and suggest that maintaining a constant RAB / demand ratio (unique for each region as a first cut for normalisation) is an appropriate indicator. To do otherwise simply allows network costs to keep increasing without bounds noting that Transgrid's RAB has doubled the change in demand since 2006.

The EUAA has applied this thinking to derive an appropriate level of total capex given Transgrid's foreseeable business climate. This approach is similar to the AER in that the expectation is that Transgrid would manage its risks and prioritise expenditure within that allowance across all capex categories. The proposed approach is to determine the level of capex that would keep the RAB in a constant ratio with demand.

The formula used for this is :

$$Additional\ Capex = [RABi\ x \left(\frac{Demand'}{Demand} - 1\right)] + Regulatory\ Depreciation$$

where : RABi = opening RAB at start of Reg period

Demand' = peak system demand at end of Reg period

Demand = peak system demand at start of Reg period

Whilst this approach is not intended to be a perfect or definitive method it does provide an indicator. The principle is quite simple, if there is no growth in demand then there should be very little / no increase in RAB. It does become problematic where demand declines as the mechanism to optimise the RAB is limited under the NER.

Regulatory depreciation is essentially the element that looks after replacement and given that regulatory depreciation is the net of straight line depreciation and the indexation of the RAB, the TNSP is kept whole from a long term revenue point of view to replace assets. Applying the above formula using Transgrid's figures (10% POE high, medium and low demand scenarios from Transgrid's 2014 Annual Planning Report, RAB and depreciation values from the revised revenue proposal) and maintaining the RAB / demand ratio constant to the 2013-14 ratio, gives the following range of outcomes.

Table 2 : EUAA derived Total Capex ranges

Scenario	Calculated Additional Capex ($2013-14)
Transgrid high forecast 10% POE	$ 953.88M
Transgrid medium forecast 10% POE	$ 794.42M
Transgrid low forecast 10% POE	$ 574.28M

Comparing to the figures proposed by Transgrid, AER and the above EUAA range.

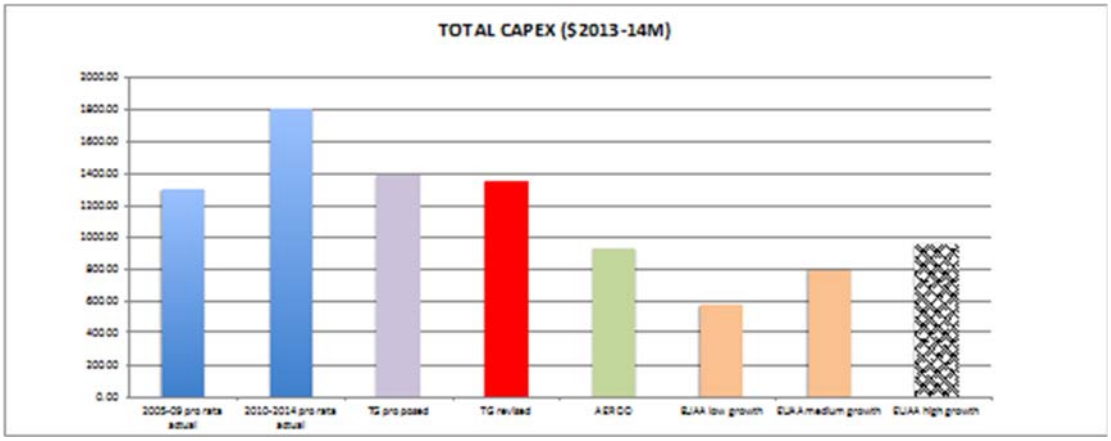
Table 3 : Comparison of EUAA capex range, Transgrid proposal and AER draft determination

	Transgrid Original Proposal	Transgrid Revised Proposal	AER Draft Decision	EUAA derived based on constant RAB / Demand
Total Capex Comparison	$1,387.69M	$1,346.41M	$922.34M	$574.28M to $953.88M [1]
Delta TG Original		-$41.28M	-$464.35M	-$813.41M to $433.81M
Delta % TG Original		-3%	-34%	-58% to -31%

[1] The $953M derived value relates to Transgrid's high forecast 10% POE and is only included for comparison purposes. Transgrid are using the medium forecast scenario for planning purposes to demonstrate the AER draft decision is conservative.

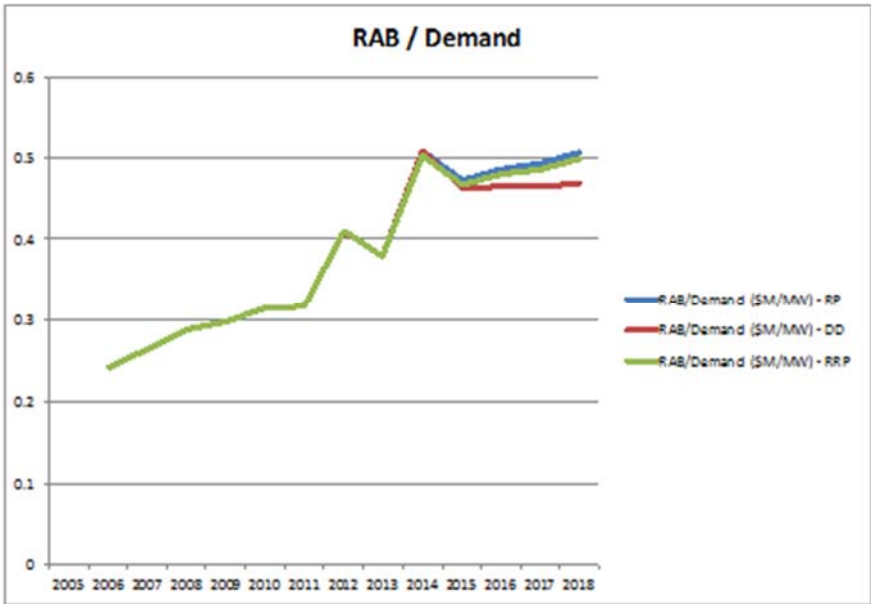
The respective data is presented graphically in Figure 4.

Figure 4 : Graphical comparison of capex proposed by Transgrid, AER and derived EUAA



The RAB / demand outcome realised by the draft determination compared to Transgrid's proposals is as follows.

Figure 5 : RAB / Demand Scenarios



It can be seen from the above, the AER draft determination broadly achieves the desired outcome of keeping RAB / demand in a relatively constant ratio. However it does err on the generous side as it has a slight upward trend. It also compares with the EUAA derived value for Transgrid's high forecast which is not being used by Transgrid.

Therefore the EUAA consider there is no case to increase capex further than the draft decision based on this outcome.

In fact there is merit in considering the total capex value calculated above using Transgrid's low 10% POE growth scenario for more certainty in favour of the customer to protect against further slowdown of demand growth. Using the above methodology, this delivers total capex of between $574M - $794M.

Taking yet another perspective – a portfolio approach. The EMCa report to the AER identified $260M overspend in replacement vs the forecast for the 2009-14 period on the basis there was "headroom" in the total capex allowance due to falling demand impacts on augmentation. If the previous period forecast was deemed an efficient baseline, taking the overspend forward as a "credit" and without adjusting any other Transgrid proposed capex category expenditure (eg 218% increase in security & compliance, etc) would result in a total allowance of around $600M.

Therefore EUAA believe that the AER need to determine that a total capex portfolio approach is appropriate with a view to maintaining growth in RAB proportional to demand.

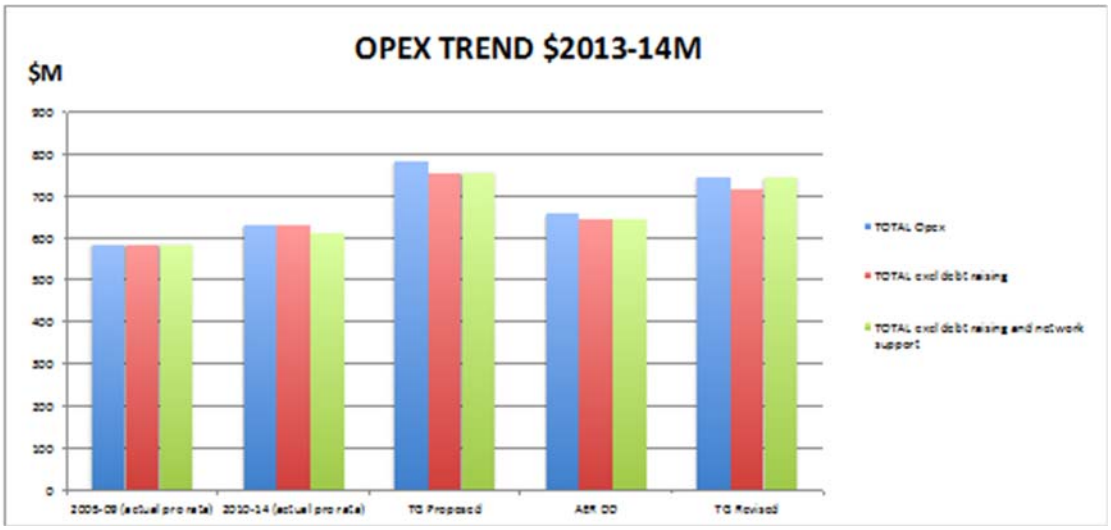
Recommendation 2

Based on Transgrid's medium and low 10% POE demand growth scenario and an objective to maintain total investment proportional to the demand, the AER consider the merits of further reduction in the total capex allowance to a range between $574M - $794M and allow Transgrid to prioritise projects within that allowance.

5 Operating expenditure

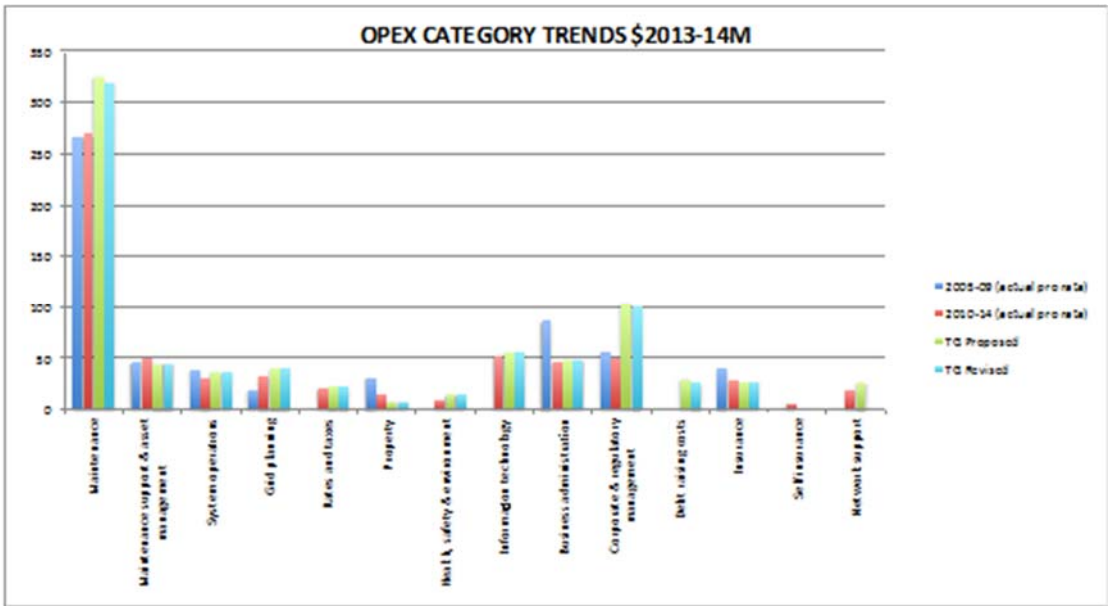
Transgrid propose an 18% real increase over the 2010-14 equivalent opex in addition to claiming over $60M in efficiency benefits via underspending against the 2010-14 AER allowance.

Figure 6 : Total Opex Trend and Comparisons[5]



The following graph provides a trend in opex categories.

Figure 7 : Trends in Opex Categories



[5]Based on Transgrid 2010-14 and 2015-18 revenue proposals

Observations

On review of the data presented, we make the following observations:

- Transgrid propose to continue an increasing real cost trend.
- The Transgrid revised proposal is only 5% lower than the original proposal.
- The AER draft determination is still 4% higher in real terms than the 2009-14 period.
- Raises questions whether the last period opex allowance was set too high based on the actuals trend between 2005-09 and 2010-15 periods.
- Transgrid are not providing any indication of returning benefits to customers based on their proposal – ie they want the EBSS plus another $110M in real equivalent terms above the previous period.
- Transgrid has not made a compelling case to justify the proposed 19% ($50M) increase in maintenance and 100% ($50M) increase in corporate and regulatory management.

5.1 Step change comments

The EUAA notes Transgrid has challenged the AER on a number of its proposed step change decisions. Firstly, an overall comment is that the increases outlined in the step changes are difficult to reconcile with the sheer magnitude of changes in maintenance and corporate / regulatory management as mentioned above. Secondly, the EUAA support the AER's position on the step changes.

New regulatory guidelines

The EUAA believe that Transgrid would have established most of the new reporting systems and incurred costs for the first round of benchmarking which would have been included in the 2010-14 regulatory period for which actual costs are already being compared – again noting Transgrid's overall underspend for that period.

Transfer of AEMO system operator functions

The real question is not simply transferring what was charged via unregulated fees to AEMO on the basis of AEMO's alternative cost to set up from scratch, but the true incremental costs that Transgrid can demonstrate in undertaking these functions. Put simply, if AEMO had taken these functions back what would Transgrid's costs reduced by? If there is no incremental cost to Transgrid, the customer should receive these benefits rather than being passed through as previously done by AEMO.

Easement maintenance

These long term average costs would surely be incorporated into the total opex costs trends.

Demand Innovation Allowance

Transgrid need to demonstrate tangible impacts between this expenditure and real reductions in peak demand. Failing this, the allowance should either be eliminated or some test applied.

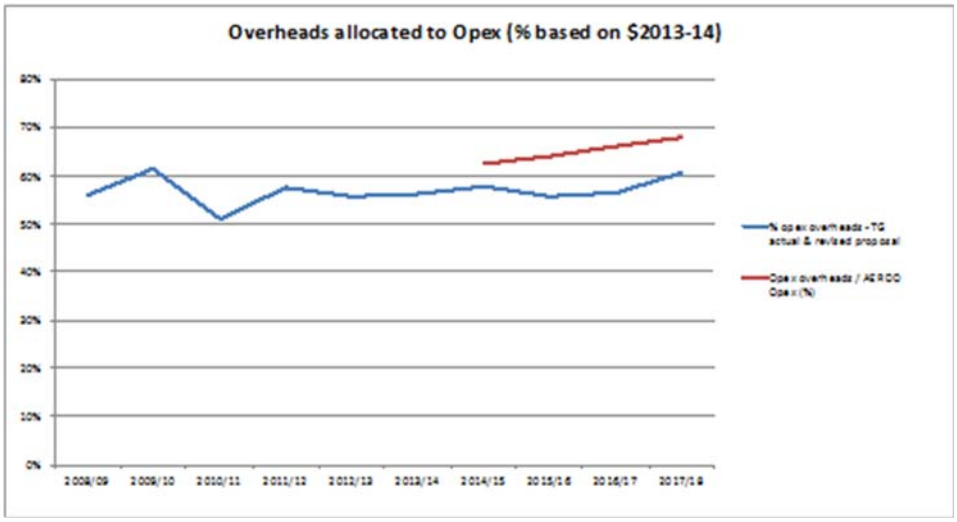
Consumer engagement program

The EUAA believe that consumer engagement should be an integral part of doing business and would expect that feedback from genuine engagement would lead to changes in services and increases in efficiencies that would more than offset the costs. If not, that should be an objective of Transgrid. On a related note, the conversion of opex increases to cents per typical residential customer annual bill to garner support does not augur well with the EUAA. We have real concerns if this approach has been used to win over consumers during consultation / surveys.

5.2 Opex overheads are significant

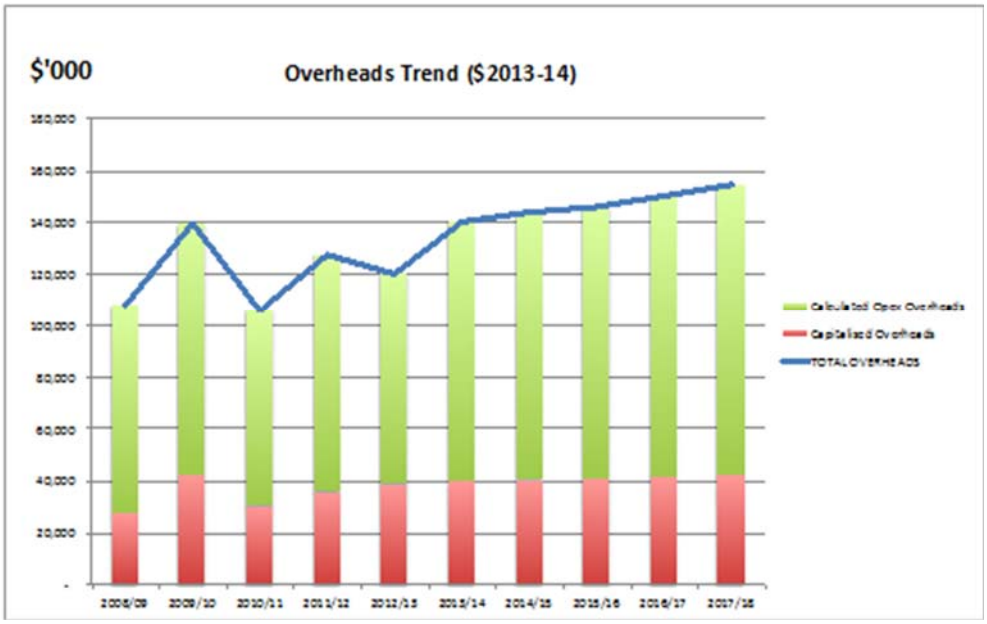
Transgrid has a high proportion of overheads assigned to opex. Overheads are >50% of the opex whereas the EUAA would expect this to be sitting more around the 30% level. The problem with this allocation is that it goes to the MAR - dollar for dollar.

Figure 8: TransgridOpex Overheads[6]



Overall overheads are forecast to rise.

Figure 9 :Transgrid Overhead Allocation Trend[7]



5.3 EUAA macro view of opex

The EUAA has thought about opex from a more macro point of view rather than arguing each opex line and offer the following.

Reduction of opex overheads

If opex overheads were reduced to around 30% instead of 55%, this would result in a total saving of around $175M. This would imply a total opex allowance of around $570M.

Removal of over forecasting

If maintenance and corporate and regulatory management were reduced to 2010-14 real cost levels and overheads were kept at 2012-13 levels, this would amount to a total reduction of around $210M. This would result in a real opex total of around $575M. However it is

[6]Sourced from Transgrid RIN data

[7] ibid 6

acknowledged that there may be some double counting of overhead in the two named opex categories.

AER Benchmarking Report

Despite arguments that the current transmission benchmarking report may have limitations, the EUAA interpretation of the MTFP results would indicate a reduction of about 25% (of 2014 levels) in opex to reach an efficient frontier among NEM TNSP peers. This would reduce the proposed opex to about $537M.

Interestingly all of these high level approaches suggest a total opex allowance below $600M in $2013-14. Note that this results in a very modest 5% reduction in real terms over the previous period. The EUAA believe this is quite realistic for organisations relentlessly pursuing efficiencies in a flat growth market.

Opex Transition

In terms of transitioning opex, the EUAA believe there should be an immediate return of benefits to customers as Transgrid has the benefit of the efficiency carryover and profit headroom to absorb the proposed opex reductions.

Figure 10 :Transgrid Profit Trend[8]

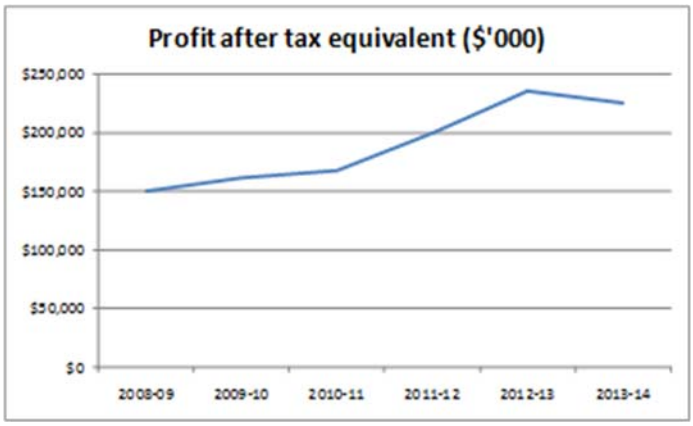
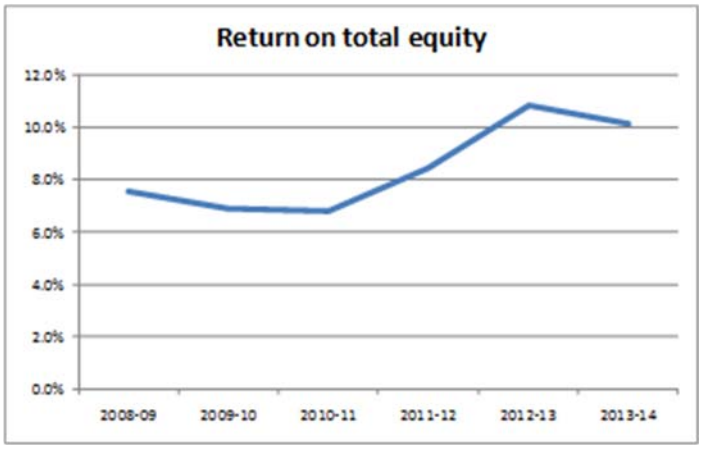


Figure 11 : Transgrid Return on Total Equity



Recommendation 3

The AER approves a total opex allowance reflecting efficiency of no more than $600M in $2013-14 and that the benefits are returned to customers immediately.

[8]Transgrid Annual Reports

6 Efficiency benefit sharing scheme

The EUAA remains sceptical in regard to the effectiveness of the efficiency benefits sharing schemes (EBSS) for customers based on the current positioning of Transgrids opex revised proposal in addition to the carry over benefit. If this scheme is to work effectively, the expectation is that efficiencies are returned to customers via opex reductions over time. If this is not going to be realised, the EUAA position is that this scheme is removed.

The EUAA are of the view that the use of benchmarking data is a better way forward in providing the right envelope for expenditure for these monopoly businesses.