Joint Customer Groups Submission by:

Australian Business Ltd

Australian Consumers Association

Energy Action Group

Energy Users Association of Australia

National Farmers Federation

TRANSGRID AND ENERGYAUSTRALIA REVENUE APPLICATION TO ACCC

14 April 2004

Prepared with the assistance of:

McLennan Magasanik Associates Pty Ltd
242 Ferrars Street
South Melbourne Vic 3205

Tel: (03) 9699 3977
Fax: (03) 9690 9881
Email: mma@mmassociates.com.au
Website: www.mmassociates.com.au

Ref: J1114

TABLE OF CONTENTS

FOREWORD

This joint customer groups submission on the ACCC's revenue reset for New South Wales transmission services provided by TransGrid and EnergyAustraia is supported by Australian Business Ltd (ABL), the Australian Consumers Association (ACA), the Energy Users Association of Australia (EUAA), the Energy Action Group (EAG), and the National Farmers Federation (NFF). As such it represents the views of consumers (large and small) of TransGrid's and EnergyAustralia's transmission services. We appreciate the opportunity to provide comments for consideration on TransGrid's and EnergyAustralia's transmission revenue cap application to the Australian Competition and Consumer Commission (ACCC). Our submission addresses the main issues of concern to our members and seeks to ensure that these issues are captured in the ACCC's consultation and decision-making processes.

The submission has been assisted by partial funding provided by the NEM Advocacy Panel and this support is gratefully acknowledged.

We had hoped to provide a combined submission covering both the TransGrid and EnergyAustralia Applications to the ACCC (including supporting documents) and the consultants' reports commissioned by the ACCC to assess expenditure proposals. However, the delays in releasing the consultant's reports on TranGrid means that we will be lodging a separate commentary on this once it is available.

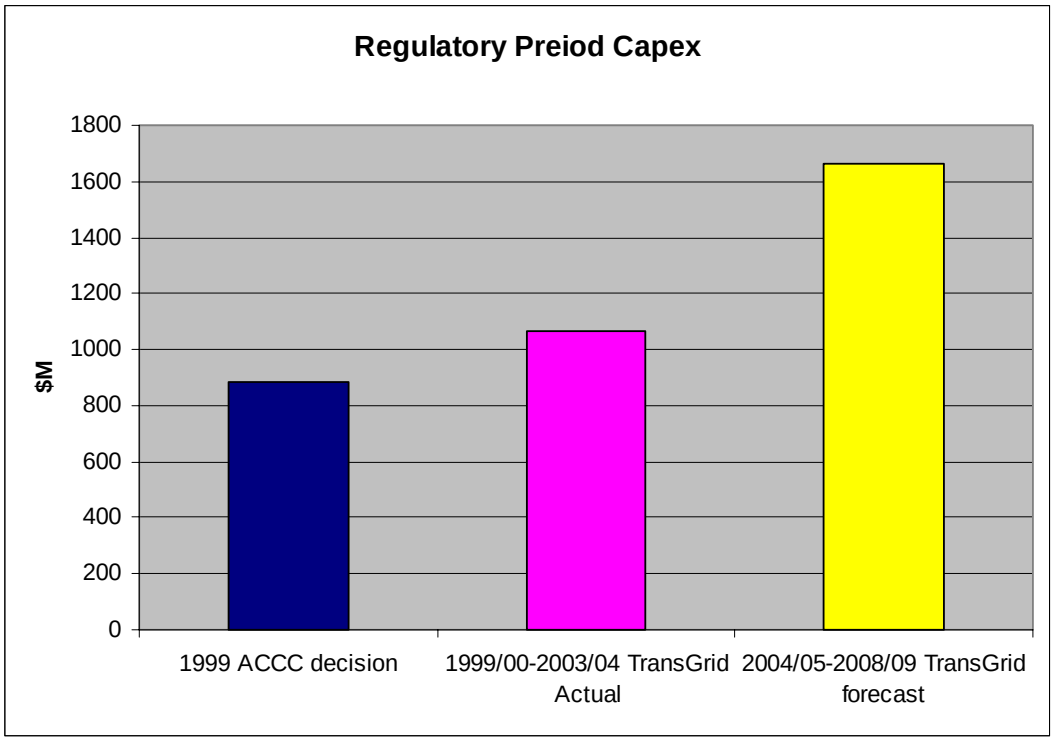
It should be noted, however, that the views expressed herein are solely those of the joint customer groups supporting the submission.

Any enquiries regarding this submission should be addressed to Mr. Roman Domanski, Executive Director of the EUAA on tel (03) 9898 3900 or email euaa@euaa.com.au.

EXECUTIVE SUMMARY

Both TransGrid and EnergyAustralia's revenue cap applications to the ACCC have inflated their revenue requirements and should not be approved by the ACCC. Consumer groups are of the opinion that these applications have significant gambit claims and seek to pass on normal business risks to customers while maintaining a high level of return.

TransGrid has claimed that have spend a total of almost $1.1B in the current regulatory period, an amount some 21% greater than that approved by the ACCC at the beginning of this period. TransGrid then attempts to roll in the full cost of this excess capex into its asset base including returns foregone. This is a blatant attempt to subvert the incentive regulation regime to its benefit. TransGrid compounds this by claiming a forecast capex of over $1.4B for the next regulatory period, some 60% over the current ACCC approved capex and 33% over its inflated actual capex.



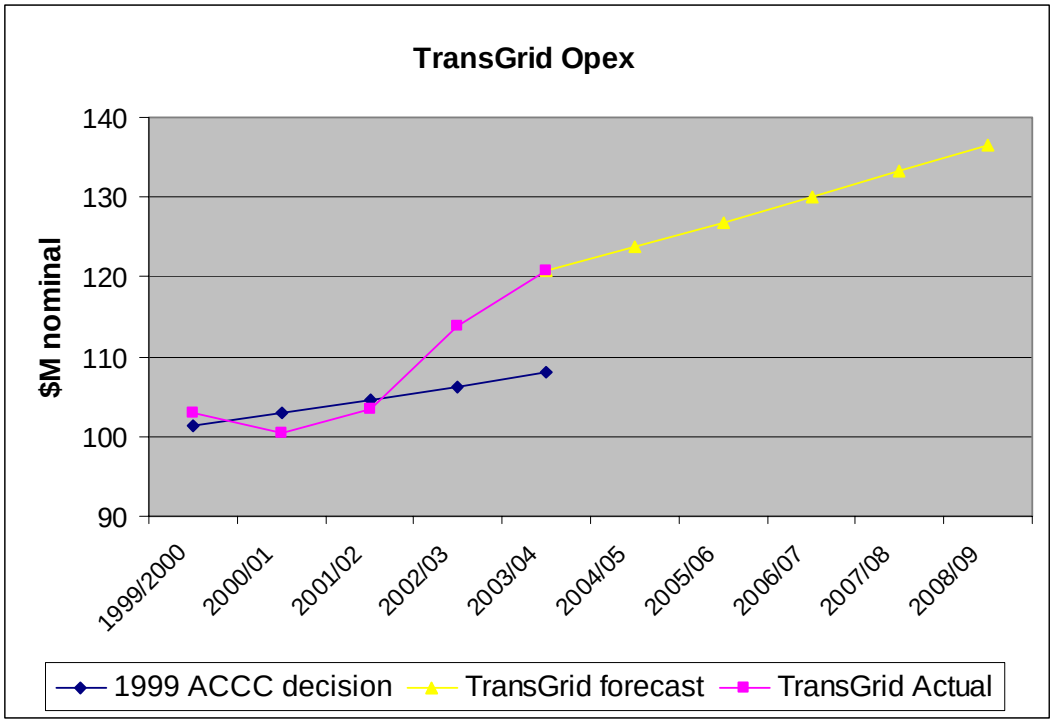
Consumer groups have a number of specific concerns with TransGrid's capex application including:

- Specific generation driven projects that should be funded by the generators involved rather than included in its general revenue cap;
- QNI related projects in response to developments in Queensland and to enable through-flows of energy between Queensland and Victorian / South Australia, via the NSW network; and

- Significantly higher actual capex incurred in the first two years of the current regulatory period than that approved by the ACCC which cannot be blamed on any unexpectedly high demand.

While TransGrid (and EnergyAustralia) has stated that it is keen to promote demand management and embedded generation, its actions have belied its statements. There is no evidence in TransGrid's application that an appropriate planning strategy to address any of the many demand management and embedded generation opportunities is in place. It is possible that forecast capital expenditure has been over-stated because the opportunity to economically defer transmission capital expenditure with embedded generation and demand management projects that have other market benefits has not been properly assessed.

Opex is another area that TransGrid application is found wanting. The gap between the ACCC approved opex for the current regulatory period and TransGrid's actual opex is growing. TransGrid has applied to increase its opex by 35% from the 1999 ACCC approved opex. Of particular concern is the pattern of opex growth. Most of the growth has occurred in the last two years of the current regulatory period which is forecast to continue into the next regulatory period. Is this an indication that TransGrid cannot find sufficient productivity gains and efficiencies to offset its operating costs and is seeking to pass on such costs to consumers? Incentive regulation is meant to promote the incentive to find efficiencies and achieve productivity gains so as to improve returns. Enterprises in a competitive environment cannot turn to a price regulator to increase prices to maintain profits in the face of cost pressures.



Regulated transmission entities have to be provided with (positive and negative) incentives for service standards, particularly related to the impacts on the energy market (for example, due to outages for scheduled maintenance). This is axiomatic given the large impact, relative to transmission costs, that the actions of transmission companies can have on energy prices and their risk premiums. In the case of TransGrid this is even more important given that the TransGrid system is pivotal to the NEM. Several authorised TransGrid outages have added significantly to market costs, although some of this cost is clearly due to the combined impact of the outage and the ability therefore created for generators to exploit constraint induced high prices.

In its previous three revenue cap decisions (PowerNet, ElectraNet and Transend), the ACCC has placed 1% of allowed revenue at risk. This implies that 99% of the TNSP's revenue is guaranteed regardless of the level of performance. In the extreme event that TransGrid's performance deteriorates dramatically, consumers are still required to fund 99% of the allowed revenue. Also, meaningful "stretch factors" need to be applied to ensure that consumers are not simply paying an incentive bonus for the better performance that the increased investments would, in any event, bring.

TransGrid claims that its pass through events is necessary "to reflect material and unexpected increases or decreases in external cost drivers" on the basis that TransGrid is unable to control such cost changes. Businesses in a competitive environment cannot simply pass costs such as these through to their consumers. However, TransGrid is unlikely to seek to pass through any exogenous cost reductions back to consumers – a fact that TransGrid has not even considered in its application. Consumers would be left with only downside risk – not upside – while TransGrid seeks to insulate itself from any risk of cost increases.

Return on capital (WACC X Asset Value) accounts for around 55% of TransGrid's annual revenue requirements. This provides strong incentives for ambit claims and exercise of 'strategic behaviour'. A 50 basis point difference in WACC results in an approximately $100 million change in revenue over the five year regulatory period. Accordingly every possible means will be employed to get regulators to agree to higher WACC values than that required to maintain investments flowing into the industry. In particular, consumer groups have concerns in the following areas of the application:

- TransGrid argues that the risk free rate chosen should be set with reference to the bond rate yield consistent with the investment horizon. This argument is spurious as it ignores the fact that refinancing of debt can readily be undertaken in a financially mature market like Australia. Given the five yearly regulatory cycle, it is more appropriate for 5 year bond rates to be used as refinancing can occur to coincide with the regulatory cycle.
- TransGrid argues that, based on the 10 year bond yield, the MRP should be 6%, but should the ACCC adopt a 5 year bond yield, then the MRP rises to 6.2%. All this is

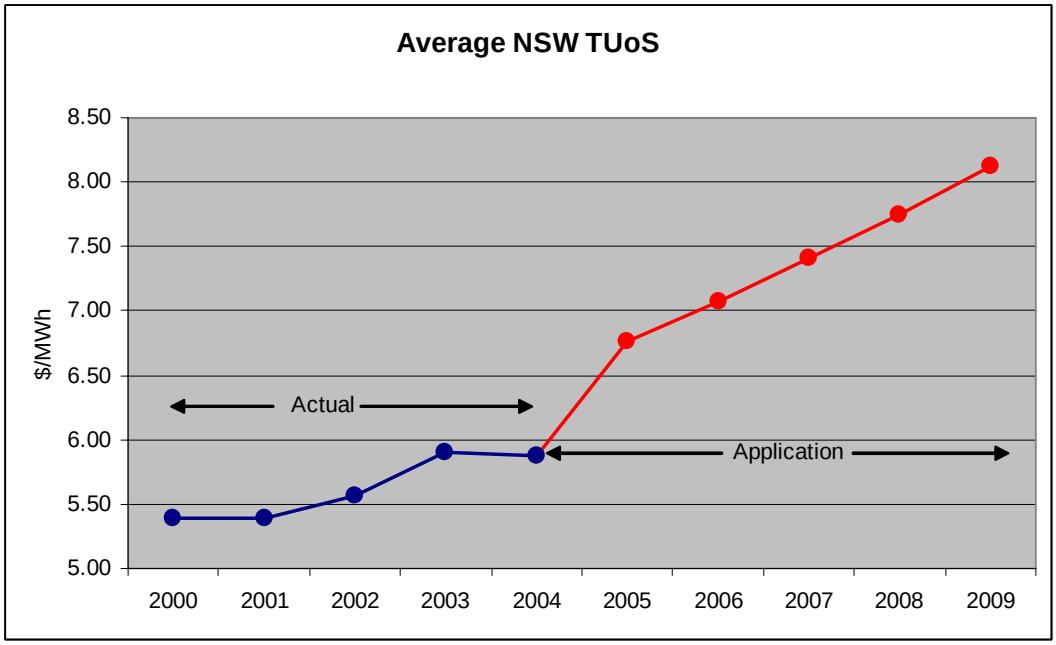
based on backward looking historical data, which tells us what the MRP was in the past but may have little relevance to how markets might behave in the future in the presence of significantly lower inflation and interest rates. Recent Australian evidence suggests that a MRP of 3.0% – 3.5% is likely to exist in the Australian financial market.

- TransGrid is proposing an equity beta of 1.12. Yet by definition, the market as a whole would have an equity beta of 1. Proposing an equity beta of 1.12 would thus indicate that TransGrid is more risky than the market as a whole. This is a not credible with 99% of its revenue guaranteed and total compensation for its costs of service assured by the regulatory arrangements. We note that the ACCC agreed in the GasNet case before the Australian Competition Tribunal that an equity beta of 1 was overly generous. It also had evidence from the Allen Consulting Group that an equity beta of 0.7 was appropriate. Accordingly, the equity beta should be significantly less than one.
- In its application, TransGrid is proposing a Debt Margin of 1.485%. This is 28.5 basis points higher than debt margin the ACCC allowed for SPI PowerNet and Powerlink, 26.5 basis points higher than that allowed for ElectraNet and 57.5 basis points higher than it allowed for Transend.
- TransGrid attempts to set the value of gamma at zero as though it were totally dependent on foreign source for equity investment. Setting gamma at zero is as inappropriate as setting gamma at one to reflect the fact that TransGrid is, in fact, wholly owned by the NSW Government. Given that TransGrid acknowledges that around 30% of the Australian market is foreign owned, gamma should be set at a level to reflect this ownership level; that is at around 0.7.

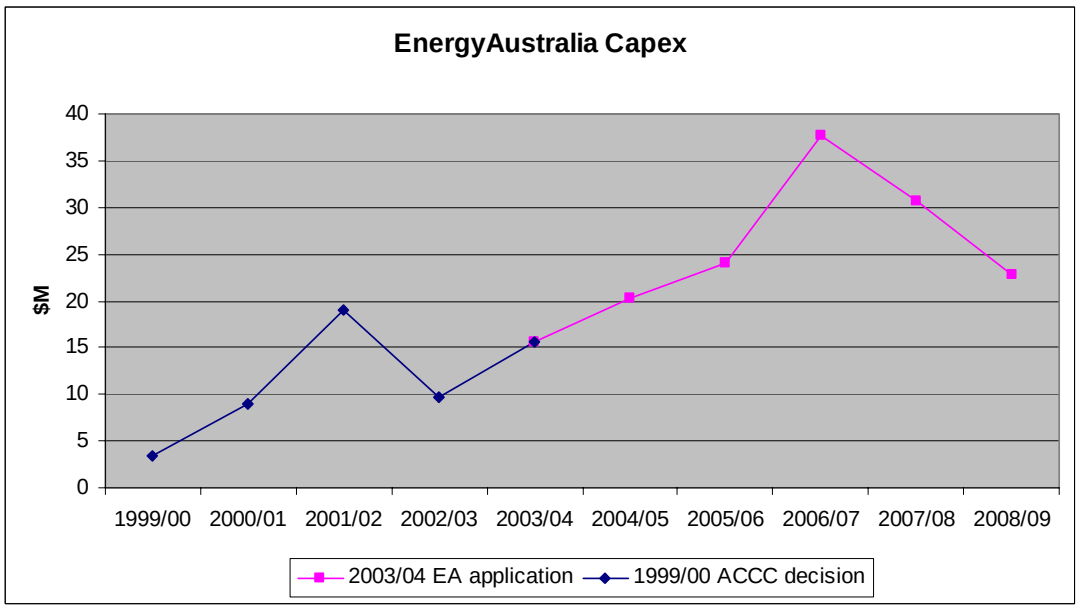
Under the TransGrid application the average TUoS payable will increase from \$5.87/MWh to \$6.77/MWh in 2004/05, a 15.3% increase in the first year of the next regulatory period. In 9 years, average TUoS prices will have increased from under \$5.40/MWh to over \$8.10/MWh, an increase of over 50%. This is despite having taken into account the actual and forecast growth in energy demand over the period.

While EnergyAustralia may not be as significant in the NSW transmission sector as TransGrid, its application also holds a number of issues that concerns consumers. The major concern in EnergyAustralia's application is the attempt to increase its regulatory asset base by over 50% on the basis that there were "significant problems with the 1999 valuation that make it an inappropriate starting point for a roll-forward for the 2004 Determination." The 1999 valuation was undertaken by the NSW Jurisdictional Regulator and was accepted for use during the previous regulatory determination. It is therefore inappropriate for EnergyAustralia to turn around at a subsequent regulatory determination to seek another revaluation. While customer groups have always held the view that the ODRC valuation method used in the 1999 valuation overstates the value of

assets, we recognise that constant revaluation creates uncertainty and potentially has significant adverse impact on the cost of equity. In its current draft determination on the NSW distribution revenue, IPART has indicated that it will not allow adjustments to the 1998 regulatory asset base as part of the roll forward methodology.

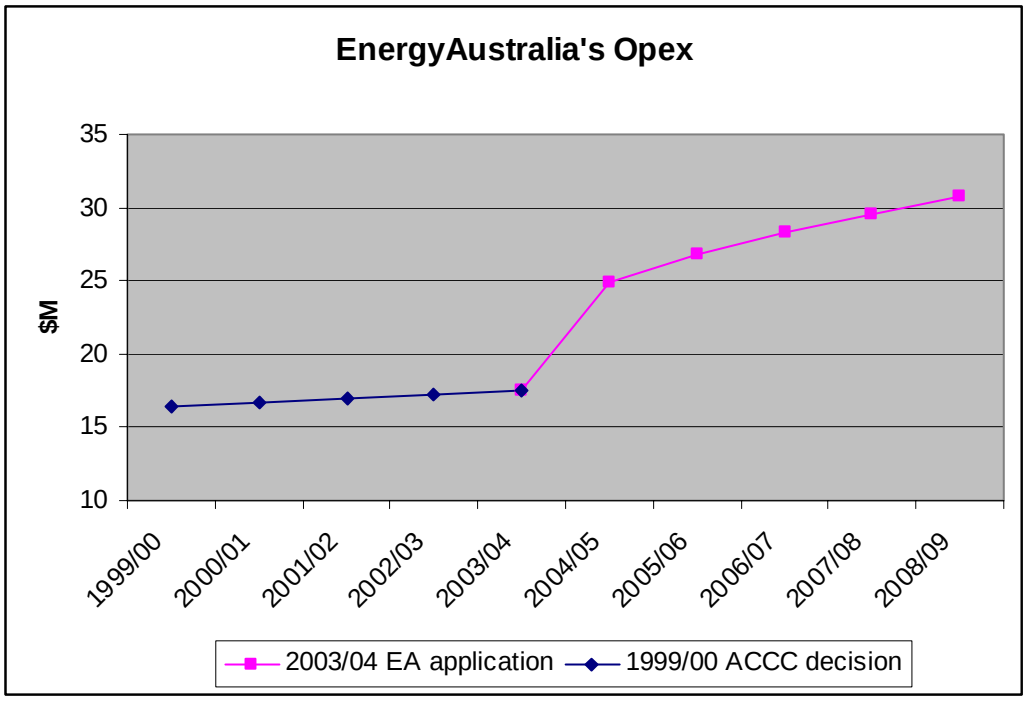


EnergyAustralia has not provided the actual capex incurred during the current regulatory period. It is thus not possible to evaluate its historical performance against the capex allowance the ACCC provided during the 1999/2000 revenue cap decision. It is, however, abundantly clear that the current EnergyAustralia forecast capex is a few orders of magnitude greater than that approved by the ACCC.



Consumers have to question if such increases in capex are justified especially given that operating expenses have not fallen from the current regulatory period but are, in fact,

forecast to increase by some 65%. This is despite the fact that EnergyAustralia has stated in its application that there will be a trade off between replacement capital and operating expenses. Base on the numbers we have obtained in its application, this trade off does not seem to have eventuated.



Other comments in relation to TransGrid's application for performance incentives, pass through and WACC also apply to EnergyAustralia.

1 INTRODUCTION

This joint customer groups submission on the ACCC's revenue reset for New South Wales transmission services provided by TransGrid and EnergyAustraia is supported by Australian Business Ltd (ABL), the Australian Consumers Association (ACA), the Energy Users Association of Australia (EUAA), the Energy Action Group (EAG), and the National Farmers Federation (NFF). As such it represents the views of consumers (large and small) of TransGrid's and EnergyAustralia's transmission services. We appreciate the opportunity to provide comments for consideration on TransGrid's and EnergyAustralia's transmission revenue cap application to the Australian Competition and Consumer Commission (ACCC). Our submission addresses the main issues of concern to our members and seeks to ensure that these issues are captured in the ACCC's consultation and decision-making processes.

In regard to TransGrid's application, our major issues of concern discussed in this response are:

- Capital Expenditure (capex) in the current regulatory period has significantly increased compared with TransGrid's previous forecasts used for setting the revenue cap for the current regulatory period. In addition, the current capex forecasts for the next regulatory period continue the trend of high rates of investments.
- The Weighted Average Cost of Capital (WACC) requested by TransGrid is not justified considering the risk reward trade off.
- The significant increase in Operation and Maintenance (O&M) expenditure over the current and next regulatory periods.
- The importance of TransGrid's performance standards in servicing end users and the inadequacy of placing only 1% of revenue at risk.
- The increase of approximately 40% in average Transmission Use of System (TUoS) charges faced by consumers as a result of the current revenue cap application.

In reviewing EnergyAustralia's application, the major issues of concern discussed in this response are:

- Capex forecast has significantly increased compared with EnergyAustralia's previous allowed capex used for setting the revenue cap for the current regulatory period.
- The Weighted Average Cost of Capital (WACC) requested by EnergyAustralia is not justified considering the risk reward trade off.
- The significant increase in Operation and Maintenance (O&M) expenditure for the next regulatory periods

It should be noted that this submission only addresses issues raised in the Applications lodged by Transgrid and EnergyAustralia and supporting documents. It does not respond to the separate consultants' reports on expenditure proposals for both TransGrid and EnergyAustralia being prepared for the ACCC. These were not available in time for

assessment prior to the completion of this submission. We will therefore be providing a supplementary response to these.

2 TRANSGRID

2.1 REGULATORY ASSET BASE AND CAPEX

In its decision in 1999, the ACCC stated that TransGrid's forecast of capex between 1999/2000 and 2003/2004 would total $881.59M.[1] TransGrid claims to have spent a total of $1,066.7M[2] over the current regulatory period including an estimate for 2003/04. This amounts to over spending by 21% of the capex forecast at the beginning of the current regulatory period. Electricity consumers, including our constituents, would be concerned with a regulatory arrangement that simply allows the monopoly regulated entity to over spend its allowed capex by such a huge margin and then bill its customers the difference during the following regulatory period by rolling in the increased costs to its asset base, asserting that the overspend was efficient. Our constituents are also concerned that the overspend is not in any way related to the "failed" attempt to develop the SNI which TransGrid has also claimed was efficient.

At a minimum, the ACCC should consider commissioning its engineering consultant to undertake a study to evaluate the efficiency of all of the capex TransGrid spent in the current regulatory period. Based on the outcome of the evaluation study, the ACCC should only allow rolling in of the increased costs of capex related to meeting any increase in customer demand. The cost of alternatives to network augmentation, for example, demand management in the shorter term and distributed generation, should be considered in determining capex. It is important that the cost of network augmentation should only be allowed where it can be shown to be the lowest cost alternative.

Increased capex incurred due to generator requirements should be paid for by generators rather than end users. Any efficient capex related cost incurred within the control of TransGrid, for example, accelerated asset replacements and renewals should be rejected and only the undepreciated value should be rolled in excluding any return on capital. TransGrid, as the asset owner, must have the incentive to manage and maintain its assets so as to minimise the total life cycle cost. Allowing TransGrid to simply roll into its asset base any cost increases would undermine and negate the whole concept of incentive regulation. Incentive is based on the premise that, should the TNSP achieve efficiencies that lead to lower capex spend in any period, it would be able to keep the benefits of this lower expenditure. As claw back is considered to diminish the incentives for the TNSP to be innovative and efficient, so too would rolling in the return foregone of the overspending. Consumers expect consistency in this regard.

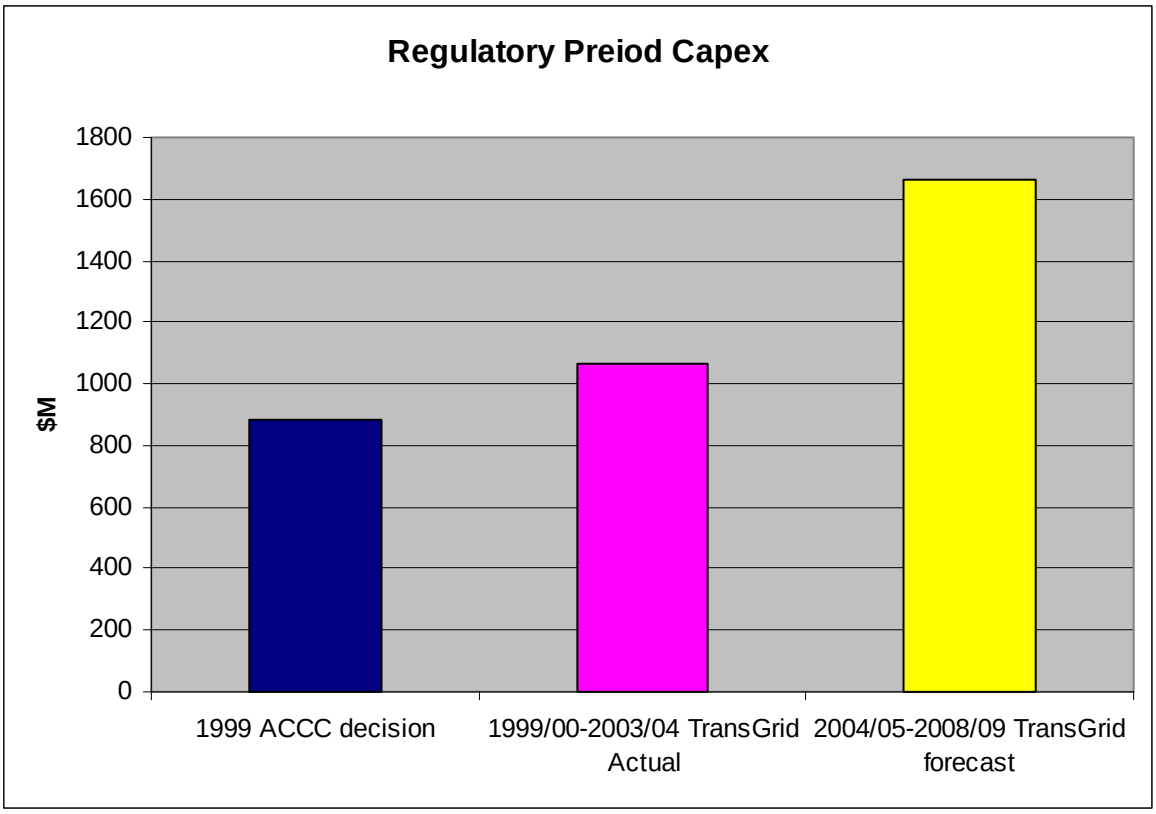
---

[1] ACCC, Decision, NSW & ACT Transmission Network Revenue Caps 1999/00-2003/04, 25 Jan 2000

[2] TransGrid 2004 Revenue Reset Application, September 2003

In its current application, TransGrid's forecast of capex, between 2004/05 and 2008/09, is set at $1,424M, which is an increase of over 60% above the amount the ACCC set for the current regulatory period and a 33% increase over the amount TransGrid claims to have actually incurred during the current period. Figure 1 shows the variation in capex between the current and next regulatory periods. After taking inflation into account (around 15% over the five year regulatory period), this implies that TransGrid requires a real increase in capex of up to 45% over the two regulatory periods. Load growth is forecast at around 17% over the next regulatory period. This compares to a load growth of around 13% over the current period. This implies that load growth is increasing by some 4-5%[3] over the two regulatory periods. Yet real capex (which is the growth of the TNSP's asset base) is growing at 45% over the same periods. It is difficult to see how a 45% increase in real capex can be justified when the increase in load growth amounts to only around 4-5% over the two periods?

Figure 1 TransGrid's Total Capex



TransGrid's request to increase the level of capex by 60% will no doubt expose energy users to an excessive level of capex over the next regulatory period. To justify their application, TransGrid should be asked to provide a detailed statement of the scope and timing of their proposed capex program that should be subjected to detailed scrutiny by

[3] Forecast growth rate of 17% minus 13% actual growth in the current regulatory period.

suitably qualified engineering consultants and be benchmarked against comparable businesses both here and overseas.

This should identify the purposes for this expenditure and provide a proper allocation of costs to the respective beneficiaries of each project or class of development work. This approach will enable the ACCC to critically assess TransGrid's claims and set a capex level, which is justified, feasible and acceptable to electricity consumers. It would also allow the energy market participants in NSW to assess their exposure to any increase in costs and to confirm whether or not off-setting benefits exceed any increase in costs.

TransGrid has also identified a number of generation driven variable projects in its revenue application.[4] We submit that, given that these projects are generation driven, the costs of these projects should be allocated and charged directly to the generators despite the fact that capital works are required to be performed on the shared network. These costs should not be paid for by consumers in the form of TUoS charges.

TransGrid states that some of the capex is allocated to support the operations of QNI. This is in response to developments in Queensland as well as enabling "through-flows of energy (in both directions) between Queensland and Victorian/South Australia, via the NSW network".[5] While such developments may be necessary for the efficient functioning of the NEM, NSW consumers should not bear the cost of TransGrid's investments with benefits flowing to generators and consumers in other jurisdictions.

The principle of beneficiaries pay should clearly apply in such cases. Augmenting the NSW transmission system to enable the flow of energy from Queensland to the southern states and vice visa does not benefit NSW customers and accordingly NSW customers should not be required to bear this cost. Application of the beneficiaries pays principle in this case would see Queensland generators responsible for these costs, which is entirely appropriate.

However, where the benefits can be shown to flow to consumers in NSW from investments in interconnection capacity, NSW consumers will be prepared to bear the increased costs. We recognise the pivotal nature of the NSW transmission system, which was highlighted on Tuesday, 9 March 2004 when NSW pool prices rose to between $3,800/MWh and $9,700/MWh (averaging around $7,400/MWh) for a 4 hr period in the afternoon. While pool prices in Queensland also rose during the same period, in Victoria, prices did not exceed $50/MWh and Victoria had significant excess capacity during the period in question. Additional capacity in the interconnection with Victoria would have enabled the excess generation from Victoria to supply the high NSW/Queensland demand thereby assisting in reducing prices in the northern regions.

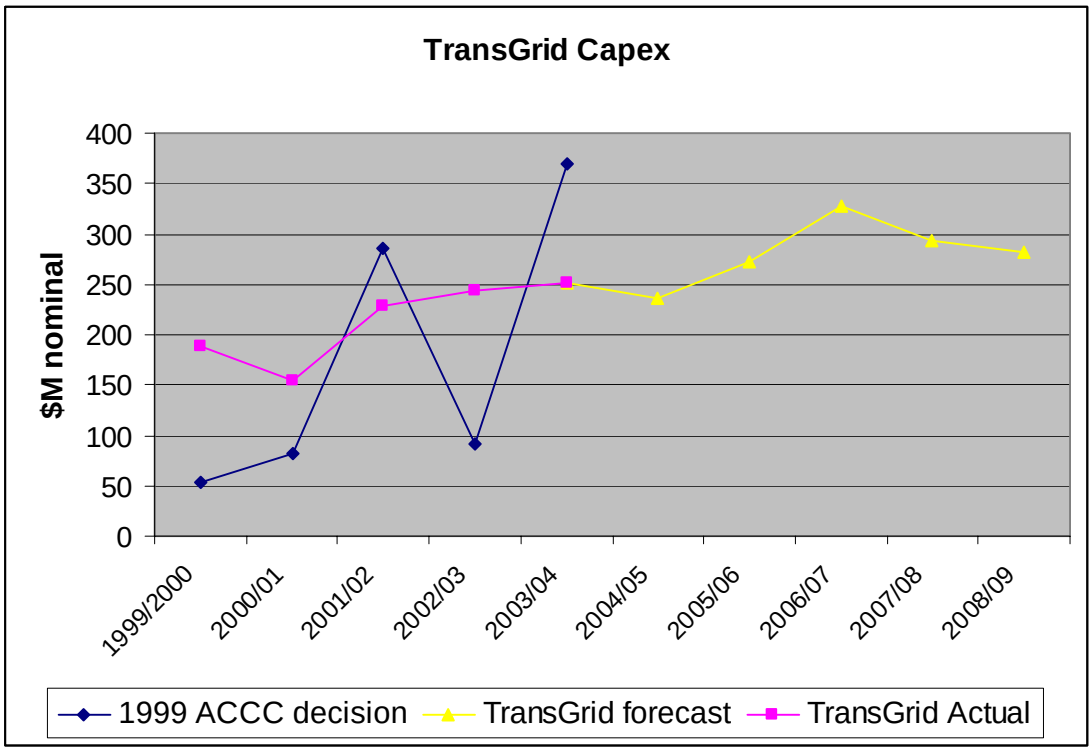
---

[4] Section 5.1.3, TransGrid 2004 Revenue Reset Application

[5] Page 61, TransGrid 2004 Revenue Reset Application

Figure 2 also highlights another concern regarding TransGrid's asset management and forecast.

Figure 2 TransGrid Capex



In 1999/2000, in the first year of the current regulatory period, TransGrid spent 3½ times its capex allowance. In the following year, it overspent its allowance by almost another 100%. Consumers must question TransGrid's competence in forecasting its capex when such difference can occur within the first two years of the regulatory period. Surely this excess in capex cannot be blamed on meeting higher than expected consumer demand within such a short period. One would expect that the anticipated level of demand within a one or two year period will be fairly accurately known to any competent TNSP. Any capital expenditure required to meet this higher level of demand must thus have been expected when the previous revenue application was made. Alternatively, if the excess capex was not due to higher demand, then it has to be due to normal asset replacement or system augmentation, and again the expected capex level must have been anticipated during the previous application.

We thus fail to see why actual capex during the first couple of years after a review should be so much higher than forecast as planning, costing and commitment to the level of capex must have been made before the previous regulatory review. It is not credible for TransGrid to over spend capex by this order of magnitude in the first two years of the regulatory period.

Figure 2 also indicates that a significant portion of capex was brought forward from 2003/04 (when TransGrid actually substantially underspent the allowed capex) to 2002/03 when the capex was overspent by almost 170%. Unless the bringing forward of capex was to meet the increase in consumer demand, consumers should not have to bear any of the resulting increase in costs. Even then, it is debatable which consumers should bear this cost.

We need to be assured that this pattern of overspending will not recur during the next regulatory period. Application of techniques such as benchmarking, external assessment of proposals, comparisons with past trends and the like are required.

2.1.1 Capex Benchmark

Benchmarking TransGrid's average capex for the next regulatory period (Figure 3) shows that it is forecasting to increase its capex spend to over 12% of its 2003 regulatory asset base (RAB)[6]. This will result in TransGrid having the highest capex to RAB spend among the NEM states. The next highest capex to RAB spend is ElectraNet at under 8.5% and TransGrid's capex to RAB ratio is over twice that of the combined Victorian TNSPs (PowerNet and Vencorp).

TransGrid cannot claim that high demand growth is responsible for this difference when all the NEM states are experiencing significant demand growth. Based on NEMMCO's *2003 Statement of Opportunities*, demand growth in the NSW and Queensland is expected to be around 3% between 2005 and 2013 while in Victoria and SA, it is expected to be around 2.5%. The small difference in growth cannot explain why TransGrid's capex to RAB ratio is so much higher than the other NEM states. When compared with Powerlink's ratio of about 7%, TransGrid's 12% is all the more inexplicable since Queensland load growth is even higher than NSW. This can be seen in Figure 4.

6 Since regulators add capex to the openring RAB to determine closing RAB after deducting depreciation, the ratio Capex to RAB has been used to benchmark across all TNSP on the same basis. This provides a measure of the amount of investment per unit of asset base. Using replacement cost rather than RAB may be a better measure. However, there are no relaible replacement values published for all TNSPs. We also believe that even if replacement values were used, the relative standing of the TNSPs would not be different and the magnitute of the difference would not be significant unless the assets are of significantly different vintages.

Figure 3 Benchmarking TransGrid Capex to RAB

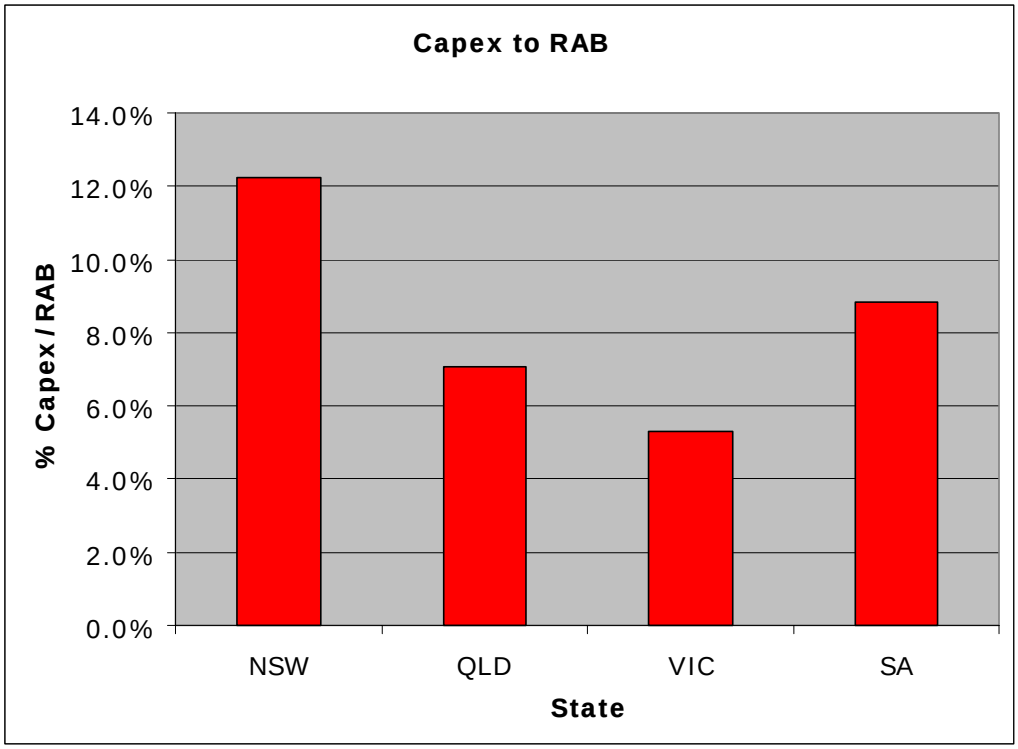
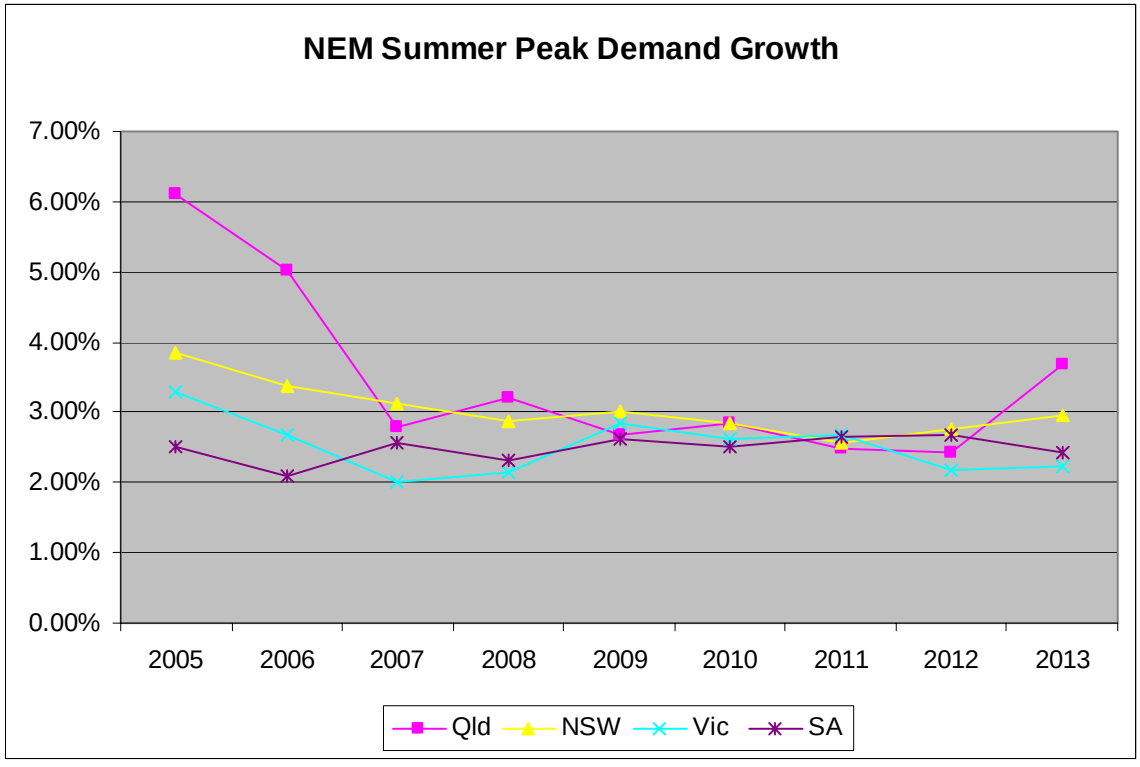


Figure 4 NEM Summer Peak Demand Growth



2.2 DEMAND MANAGEMENT AND EMBEDDED GENERATION

In 1999, TransGrid and EnergyAustralia published a consultation paper[7] to canvas options to supply electricity to Sydney's CBD and inner suburbs. One of the main aims of the paper was to develop alternative options to increasing network capacity and include consideration of cogeneration, embedded generation and demand side response. In 2002, TransGrid and EnergyAustralia implemented a Demand Management Strategy to defer or avoid network expansion in the inner metropolitan Sydney area. However, despite these initiatives, TransGrid's application does not provide any detail on how cogeneration, embedded generation and demand management has been considered to reduce the need for increased network augmentation. The lack of emphasis on these important options in its application leads one to believe that little has been accomplished or that little effort has been expended in determining how cogeneration, embedded generation and demand management can be encouraged to avoid the need for increases in high cost network capacity.

As recently as June 2003, NEMMCO published a paper providing projections for cogeneration and embedded generation[8] undertaken by the National Institute of Economics and Industry Research. In its report, NIEIR found that total cogeneration capacity in NSW could double from 320MW in 2001 to 746 MW by 2018. With the various schemes operating in NSW including the Sustainable Energy Development Authority's Energy Smart and Green Power initiatives and the NSW government's NGAC Benchmark Scheme, one would expect that cogeneration, embedded generation and demand management alternatives would more prominent in TransGrid's operations and in its Application to the ACCC for this reset. TransGrid, however, relies on the traditional generation and network expansion solutions to meet the increased demand.

The NIEIR report to NEMMCO, indicates that there are several possible small scale (under 30MW) embedded generation and cogeneration projects that could be developed in NSW which would off-load or support the network under heavily loaded conditions. However, it is also evident that the difficulties proponents have in negotiating appropriate terms and conditions that recognise the benefits of their projects in avoiding or deferring future network investments show that network owner's interests lie in traditional network augmentation. There is no evidence in TransGrid's application that an appropriate planning strategy to address these opportunities is in place. It is possible that forecast capital expenditure has been over-stated because the opportunity to economically defer transmission capital expenditure with embedded generation and demand management projects that have other market benefits has not been properly assessed.

---

[7] TransGrid & EnergyAustralia, Consultation Paper – Supply to Sydney's CBD and Inner Suburbs, January 1999

[8] NIEIR, *Projections of cogeneration and embedded generation in NEM regions*, June 2003

We note that Powerlink Qld is in the habit of regularly publishing draft and final reports on network augmentations that include the consideration of alternative generation and demand side options.[9]

The ACCC needs to ensure that TransGrid and EnergyAustralia actively consider and encourage the development of embedded generation and demand management alternatives especially so in an environment where peak demand is growing at a rate greater than energy growth. The benefits of embedded resources on a $/kWh avoided are even greater when networks are exposed to short duration and infrequent peaks that are typical of extremely hot days. While we acknowledge that there may be some issues with how the system can ensure that such non-network alternative will be available during times of system stress, more needs to be done to encourage a solution which will lead to an overall lower cost. That network operators' revenue is dependent on network expansion, in large part because of the incentives in the current regulatory regime, is a significant impediment to the development of demand side response even though such development would almost certainly lead to lower overall cost.[10] Based on our experience and exposure to these matters over time (in both transmission and distribution), it is also our view that there are certain significant ways in which non-network solutions do not encounter a level playing field as yet. This includes inadequate notice periods of potential opportunities to allow non-network solutions to be developed, a lack of information about opportunities, a lack of players with the ability to co-ordinate such options, a lack of end-user knowledge and education and other factors. Attention to all these issues is needed. However, it would be unfair and inappropriate for individual TNSPs to be left with the sole responsibility for this. Policy makers, regulators, retailers, customers, aggregators and bodies such as the EUAA all have a role to play. Options such as the Demand Management fund that IPART has proposed, providing NSPs with sharper incentives to peruse non-network options and measures such as those proposed in the EUAA's recent trial of a Demand Side Response Facility for the NEM are all worth serious consideration, including by the ACCC in this review.

2.3 OPERATING AND MAINTENANCE EXPENDITURE

In 1999/2000, the ACCC approved TransGrid's O&M expenditure amounting to some $523M over the five year period from 1999/2000 to 2003/04. Over this period, TransGrid's actual O&M is estimated to be approximately $18M greater than the ACCC

[9] Whilst these reports in themselves cannot offer a 'level playing field' for non-network alternatives, they show a level of commitment to following the process. The EUAA regularly watches these processes and has commented or sought clarification from Powerlink in several instances. We welcome the transparency shown by Powerlink and acknowledge that they have taken a number of steps to include non-network alternatives in their options, it is still disappointing that only one case so far has resulted in a non-netwrk solution being implemented.

[10] It is also clear from our discussions on the matter that network solutions, especially in sensitive areas, can create a plethora of planning, technical, infrastructure, environmental regulatory hurdles that can dealy construction and increase costs.

allowed amount. Of greater concern is the fact that the gap between the ACCC approved amount and the actual opex amount that TransGrid spent has been increasing. TransGrid, however, claims that this overspend represents improved efficiency due to various factors including:

- Wages increasing faster than inflation;
- Growth in its network;
- Age of assets; and
- Exogenous cost increases.

While we do not doubt that TransGrid faces some cost pressures, all enterprises in the economy face similar ones. Nevertheless companies in a competitive environment cannot simply pass on their higher costs by increasing prices. Cost increases must be addressed by productivity gains and improved efficiencies. The alternative is loosing market share and reduced profits. It is only when productivity gains and efficiencies are greater than cost increases that enterprises would enjoy improved returns. If TransGrid cannot find sufficient productivity gains and efficiencies to offset its operating costs, then its returns should similarly suffer.

Is this not what "incentive regulation" is meant to promote – the incentive to find efficiencies and achieve productivity gains so as to improve returns? Enterprises in a competitive environment cannot turn to a price regulator to increase prices to maintain profits in the face of cost pressures. Figure 5 shows TransGrid's opex over the current and next regulatory periods.

Of greater concern to consumers, TransGrid in its application has based its forecast opex from the very high base level of opex in 2003/04. This trend can be seen clearly in Figure 6.

There seems to be a trend appearing in regulatory price reviews that in the initial years immediately after a price review decision is made, operating costs are in line with the regulatory decision. However in the later years, these costs increase substantially and forecasts are then based on these higher costs. Is this an indication of the "regulatory games" that regulated businesses are playing?

By the end of the next regulatory period, the opex cost increases amounts to some 35% over the two periods as shown in Figure 5. This equates to an annual increase of about 3.4%, more than twice the annual increase approved by the ACCC during the previous review (1.6%). Most of this increase is due to the step up in cost from $108M to $124M, or about a 15% increase in the first year of the next regulatory period.

Accordingly, TransGrid's O&M expenditure needs to be examined closely by the ACCC and pared back significantly to reasonable and efficient levels before consumers would

accept it as reasonable. Application of techniques such as benchmarking, external assessment of proposals, comparisons with past trends and the like are required.

Figure 5 TransGrid's Opex

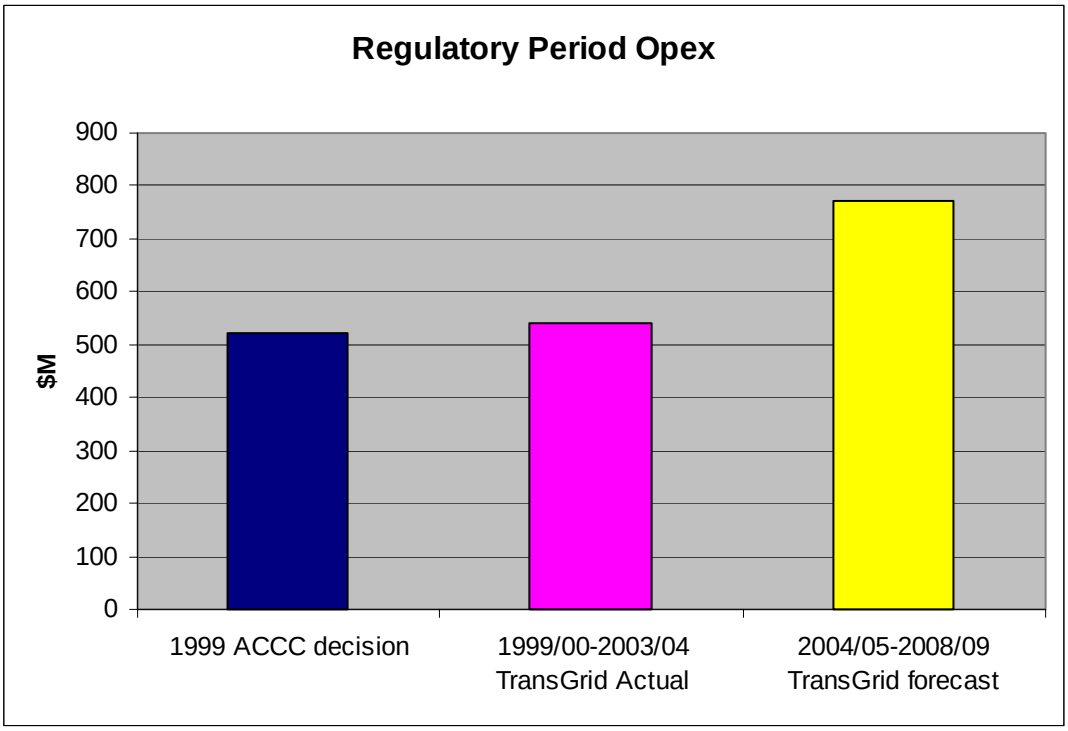
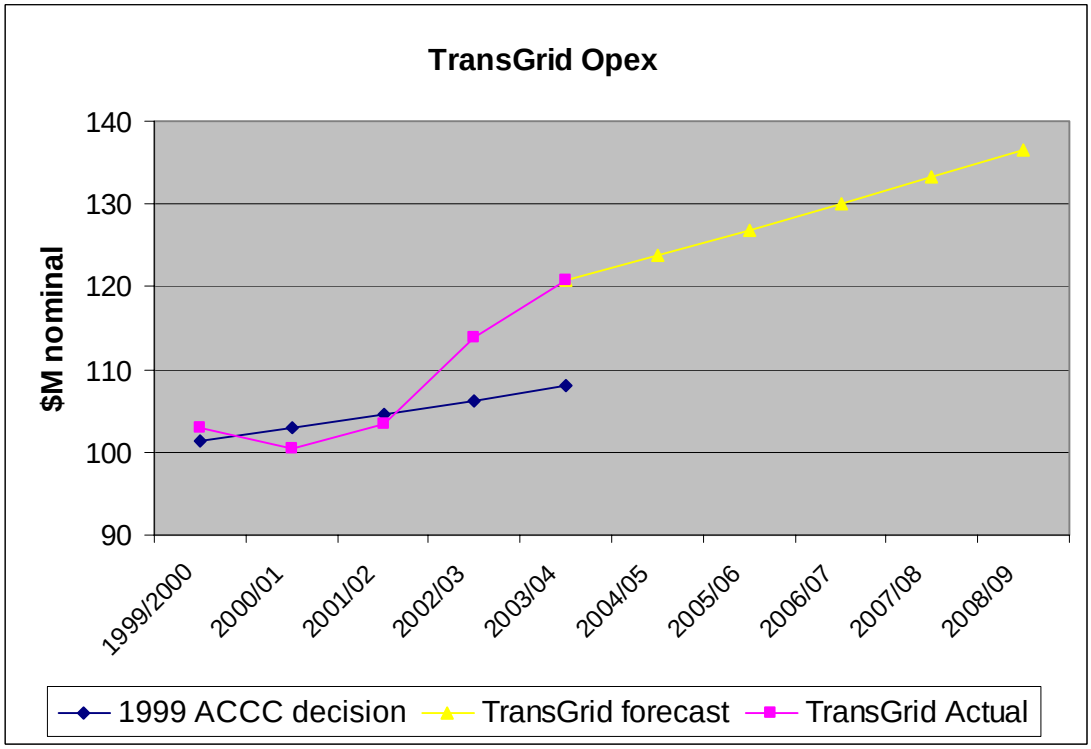


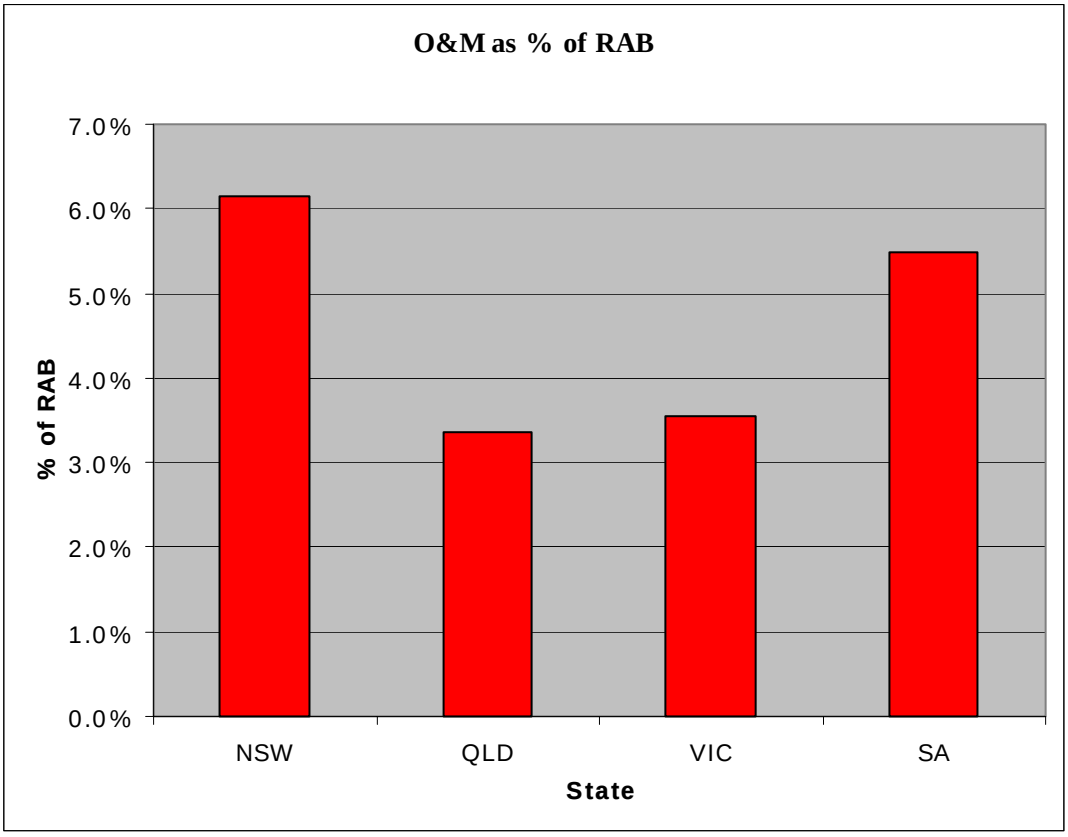
Figure 6 TransGrid Opex



2.3.1 Opex Benchmark

Benchmarking TransGrid's forecast average opex spend as a percentage of its 2003 RAB (Figure 7) shows a similar pattern observed for its capex spend. TransGrid's average opex would amount to over 6% of its 2003 RAB, almost twice Powerlink's average opex spend.

Figure 7 Benchmarking TransGrid Opex to RAB



2.4 SERVICE STANDARDS AND PERFORMANCE INCENTIVE

Consumer groups believe that it is important that electricity users in NSW obtain a reasonable level of service from the transmission system. We welcome the steps the ACCC has taken to date in requiring TNSPs to implement some (limited) service standards but believe that further steps are urgently needed to establish a more effective and meaningful system of (positive and negative) incentives for service.

The ACCC would be aware of our strong views on the need for regulated transmission entities to be provided with (positive and negative) incentives for service standards, particularly related to the impacts on the energy market (for example, due to outages for scheduled maintenance). This is axiomatic given the large impact, relative to transmission costs, that the actions of transmission companies can have on energy prices and their risk premiums. In the case of TransGrid this is even more important given that the TransGrid system is pivotal to the NEM. Several authorised TransGrid outages have added

significantly to market costs, although some of this cost is clearly due to the combined impact of the outage and the ability, therefore created, for generators to exploit constraint induced high prices.

Consumers have also previously recommended that performance incentives for transmission entities would be more effective if applied uniformly across the NEM. Completing reviews and revenue re-sets for all regulated TNSPs at the same time would best do this. This highlights once again that the current arrangement of piecemeal review of individual TNSPs at different times is costly, inefficient and substantially reduces the benefit to end users of regulation. The ACCC is permitted sufficient discretion in the Code to allow the alignment of regulatory reviews for all TNSPs at the same time.

End use consumers once more call for the ACCC to act on this matter. The revenue reset for Transgrid is the first transmission reset before the ACCC and should be used to ensure progress on this matter. If it is not, the current misalignment of reviews will continue for at least another round of resets.

Traditionally, TNSPs have achieved fairly high reliability levels. Consumer complaints regarding reliability are largely directed at distribution networks rather than the transmission system. However, an area where the transmission system has a significant impact is the effect planned and forced transmission network outages have on the pricing of energy in the wholesale electricity market. Inappropriately timed outages on the transmission system could significantly affect energy prices in the various energy market nodes leading to increased risk faced by retailers (and consumers). This results in a higher premium charged to consumers as retailers seek to cover their exposure through higher cost one way hedge products. Accordingly, effects of transmission outages on the wholesale electricity market should be taken into account in assessing the performance of TransGrid.

The ACCC needs to resolve this question of outage scheduling as a matter of priority. While there seems to be two sides to this debate; one advocating the predictability of outage scheduling and the other promoting outage scheduling in response to spot pool prices, is it not possible that a combination of both positions may produce the best result? That is, outages may be scheduled on a number of option dates, with the final decision made in response to forecast spot pool prices in the pre-dispatch or reserve margins in the short-term PASA.

In its previous three revenue cap decisions (PowerNet, ElectraNet and Transend), the ACCC has placed 1% of allowed revenue at risk for under performances. This implies that 99% of the TNSP's revenue is guaranteed regardless of the level of performance. In the extreme event that TransGrid's performance deteriorates dramatically, consumers are still required to fund 99% of the allowed revenue. Clearly the commercial financial incentive of placing just 1% of revenue at risk is inadequate. That the full revenue is achieved by just meeting the average historical performance level shows just how much

the regulatory framework protects the TNSPs. In the normal competitive environment that most of TransGrid's consumers operate in, just meeting the average historical performance level would not guarantee past market share. Enterprises in a competitive economic environment must constantly improve their performance just to maintain their position. Only when its performance improvements are greater than its competitors would an enterprise begin to enjoy growth in revenues. Incentive regulation is meant to mimic the competitive market place and the ACCC needs to apply this competitive discipline to the businesses it regulates.

In previous decisions, the ACCC had structured its performance incentive scheme to achieve "revenue neutrality", whereby the TNSP's revenue over the regulatory period would be largely unaffected should the TNSP meet its historical performance levels. Consumers, however, would expect that, with consistently increasing capex and opex, TNSP's performance would generally be improving. As a result, the performance incentive scheme would serve to provide up to a 1% increase in revenue to the TNSP on the back of investments that consumers are already paying for, with little downside. Meaningful "stretch factors" need to be applied to ensure that consumers are not simply paying an incentive bonus for the better performance that the increased investments would, in any event, bring.

On a related issue, TransGrid and other TNSPs are generally regulated via a revenue cap. As such, these monopolies face little, if any, volume risk both in terms of energy, maximum demand, as well as consumer numbers. Should a consumer reduce electricity consumption due to lower production or closure of the business, all other consumers will have to pay more transmission charges to "compensate" for the reduced revenue. In the event that a consumer leaves (eg a mine ceases operations), the cost of transmission services for other consumers would rise accordingly to restore TransGrid's revenue target. Even if TransGrid's performance falls and the quality of its services deteriorates leading to a lower demand, TransGrid's revenue, under this regulatory arrangement, is assured with the transmission charges rising to compensate for the losses in volumes. This provides very little incentive for TransGrid to produce a quality product to retain consumers and maintain volume.

This contrasts to price caps faced by some distribution NSPs (eg in Victoria), whose regulated charges are based on average prices. These distributors at least face the prospect of lower revenues should volumes, demand or consumer numbers fall below forecast.

2.5 DEPRECIATION

While TransGrid indicates that most of its assets are depreciated on a straight line basis over the asset life of the asset class, it has applied to accelerate the depreciation for certain assets including the:

- Tuggerah-Sterland line.
- Yass- Wagga line.
- Yass 330kV substation.
- Orange 132kV substation.

No information has been provided to justify the application for accelerated deprecation except an indication that these are replacement assets (rather than additional assets being constructed) in order to re-use line routes. We do not understand how this constitutes a reasonable explanation for accelerated deprecation.

2.6 WORKING CAPITAL

TransGrid has applied to be compensated for its working capital by including a return on its working capital requirements in its allowed revenue. This simply cannot be justified as being similar to other capital assets. As TransGrid acknowledges, all enterprises have a working capital requirement. Yet in other enterprises, working capital is usually held in some income producing, at call, account that produces the only return for working capital. TransGrid should not be rewarded any differently with regards to the returns on working capital compared to other enterprises. Doing so would simply avoid another competitive discipline on a regulated monopoly entity and entitle TransGrid to "double-dip" on the returns achieved on its working capital.

2.7 COST PASS THROUGH

In its application to pass through to consumers cost increases associated with:

- A Change in Taxes Event;
- A Service Standard Event;
- An Insurance Event;
- An Unforeseen External Event; and
- Grid Support Payments;

TransGrid is attempting to shift all risk to consumers.

TransGrid claims that these pass through events are necessary "to reflect material and unexpected increases or decreases in external cost drivers" on the basis that TransGrid is unable to control such cost changes. Once again, TransGrid is attempting to avoid pressures that any other enterprise in a competitive environment must face. Businesses in a competitive environment cannot simply pass costs such as these through to their consumers. The only exception to this is perhaps a change in taxes but even then, as we saw in the case of the GST, competitive pressures may force some businesses to absorb part or all of the GST instead of passing it through to consumers at least in the short term.

In addition, TransGrid needs to clarify what "an unforeseen external event" constitutes. The event is couched in terms that could mean just about anything and is therefore unacceptable. In the other types of events, TransGrid remains the entity in the best position to manage its exposure rather than consumers who have no leverage whatsoever. These events should be managed by TransGrid's insurance for "unforeseen events", captured within its cash flow requirements. Applications for cost pass though open the possibility that TransGrid is attempting to "self insure" for certain events and if the event does occur, consumers would be forced to 'come to the rescue'.

Should this application for cost pass through be approved, TransGrid will seek to pass through any cost increases that it considers beyond its control. However, it is unlikely to seek to pass through any exogenous cost reductions back to consumers – a fact that TransGrid has not even considered in its application. Consumers would be left with only downside risk – not upside – while TransGrid seeks to insulate itself from any risk of cost increases.

Risk is an intrinsic part of any business. The pass though events notified by TransGrid are risks faced by all businesses.

2.8 WEIGHTED AVERAGE COST OF CAPITAL

Return on capital (WACC X Asset Value) accounts for around 55% of TransGrid's annual revenue requirements. This provides strong incentives for ambit claims and exercise of 'strategic behaviour' (i.e. gaming of the process, setting of parameters and associated information). A 50 basis point difference in WACC results in an approximately $100 million change in revenue over the five year regulatory period. Accordingly every possible means will be employed to get regulators to agree to higher WACC values than that required to maintain investments flowing into the industry.

We provide some comments on specific components of WACC in the following sections.

2.8.1 Risk Free Rate

TransGrid argues that the risk free rate chosen should be set with reference to the bond rate yield consistent with the investment horizon. This argument is spurious as it ignores the fact that refinancing of debt can readily be undertaken in a financially mature market like Australia. Given the five yearly regulatory cycle, it is more appropriate for 5 year bond rates to be used as refinancing can occur to coincide with the regulatory cycle. UK experience suggests it would be reasonable to expect that the 5 year bond rates would prove to be a few basis points lower than the 10 year bond rates and inflation estimates, thus leading to a slightly lower WACC. There is no reason why the bond yield period should be different from the regulatory period under consideration.

2.8.2 Market Risk Premium (MRP)

TransGrid argues that, based on the 10 year bond yield, the MRP should be 6%, but should the ACCC adopt a 5 year bond yield, then the MRP rises to 6.2%. All this is based on backward looking historical data, which tells us what the MRP was in the past but may have little relevance to how markets might behave in the future in the presence of significantly lower inflation and interest rates. We note that whilst other WACC parameters are forward looking, the estimation of the MRP remains the only WACC parameter that still relies on backward looking historical trends. Information available to the ACCC from its own consultant indicates that, in recent years, MRP has been trending down. Prof Davis[11] estimated that the appropriate forward looking MRP is between "4.5% and 7% with figures at the lower end more applicable".

The ACCC should note that UK regulators have all adopted a forward-looking market views in estimating the MRP. UK regulators adopt substantially lower values for the market risk premium (of 3.5% - 4.0%) than do Australian regulators, who all adopt values around 6.0%. In its Statement of Regulatory Principles (SoRP) Discussion Paper, the ACCC stated that it believed that this difference is due to segmented stock markets, and that investors require a higher risk premium to invest in the Australian market. We, however, see no evidence of this segmentation, neither of stock markets nor of investors requiring a higher risk premium in Australia. Indeed, while there is evidence that debt costs are different (and this is taken into account by the risk free rate and debt premiums) there is evidence that Australia is fully integrated into competitive international debt and equity markets.

In its report for the Electricity Consumers Coalition of South Australia, *Further Capital Market's evidence in Relation to the Market Risk Premium and Equity BETA Values*, dated December 2003, Headberry Partners and Bob Lim & Co found that the average MRP over the period 1970 - 2001 is 3.30% (as measured against 5 year bonds) and 3.03 (measured against 10 year bonds). Inflation over the same period averaged 3%. Recent regulatory decisions using an MRP of 6% grossly inflate the returns on equity above the level required by the market.

In the meantime, we are still seeking an answer to a question posed to the ACCC in the EUAA's submissions on SPI PowerNet, ElectraNet and Transend:

> *Should/do financial markets see Australian utilities as being 'less efficient' or 'more costly' than their UK and US counterparts, particularly when other capital-intensive (but unregulated) Australian companies are able to be competitive internationally for capital and debt funding?*

[11] Davis K., 'The Weighted Average Cost of Capital for the Gas Industry', a report of the Commission and ORG, 1998

We believe that the answer to this question is that international financial markets do not see Australian utilities as less efficient and more costly to finance than their UK and US counterparts. That Australian regulators persist with decisions that suggest the opposite indicates that they are out of step with financial markets. These outcomes may well be the result of overly-cautious regulation, or regulatory error, and there is a real possibility that regulators are contributing to a reduction in the competitiveness of the Australian economy.

2.8.3 Equity Beta

TransGrid is proposing an equity beta of 1.12. In its application TransGrid acknowledges "Equity betas compensate the owners of equity for the riskiness of owning the business." Yet by definition, the market as a whole would have an equity beta of 1. Proposing an equity beta of 1.12 would thus indicate that TransGrid is more risky than the market as a whole. This is a preposterous with 99% of its revenue guaranteed and total compensation for its costs of service assured by the regulatory arrangements. We cannot emphasis strongly enough - that there is no risk in this business!

Accordingly, the equity beta should be significantly less than one. This position is supported by the ACCC's own consultant, the Allen Consulting Group which, in its report to the ACCC, *Empirical Evidence on Proxy Beta Values for Regulated Gas Transmission Activities*, dated July 2002, suggested an equity beta of under 0.7 for Australian gas transmission companies based on Australian market data. The ACCC has also suggested that it is willing to consider equity betas as low as 0.35, as in the discussions on the draft Statement of Regulatory Principles (SoRP). In addition, we note that the ACCC agreed in the GasNet case before the Australian Competition Tribunal that an equity beta of 1 was overly generous. That the ACCC has chosen to ignore its own consultant's advice and its own research into this matter in its past decisions is regrettable. It needs to set the record straight in this decision.

We note the ACCC statement in its Final Decision on Transend's transmission revenue application that in future regulatory decisions it would incorporate equity betas, which reflect market information more accurately and urge it to do so here.[12]

2.8.4 Debt Margin

In its application, TransGrid is proposing a Debt Margin of 1.485%. This is 28.5 basis points higher than debt margin the ACCC allowed for SPI PowerNet and Powerlink, 26.5 basis points higher than that allowed for ElectraNet and 57.5 basis points higher than it allowed for Transend. While we are concerned that there does not seem to be any

[12] ACCC, Tasmanian Transmission Network Revenue Cap 2004-2008/9: Decision, 10 December 2003

consistency in these values, and the ACCC has provided no satisfactory explanation for the differences, the TransGrid application is clearly outside the realms of reasonableness and needs to be significantly reduced.

2.8.5 Value of Franking Credits

The attempt by TransGrid to set the value of franking credits (gamma) at zero must surely be an ambit claim. As TransGrid has also stated, Schedule 6.1, Clause 2.1 of the NEC requires that the cost of capital be measured by the:

> "rate of return required by investors in a privately-owned company with a risk profile similar of that of the network company."[13]

TransGrid attempts to set the value of gamma at zero as though it were totally dependent on foreign source for equity investment. Setting gamma at zero is as inappropriate as setting gamma at one to reflect the fact that TransGrid is in fact wholly owned by the NSW Government

The ACCC and other jurisdictional regulators have in past decisions largely settled on a gamma value of 0.5. While we acknowledge that this issue is contentious, there seems to be little justification for the use of such a value. It seems that the reason 0.5 has been used is almost as a halfway compromise between the values of zero and one. Given that TransGrid acknowledges that around 30% of the Australian market is foreign owned, should gamma then not be set at a level to reflect this ownership level; that is at around 0.7?

2.9 AVERAGE TRANSMISSION PRICES

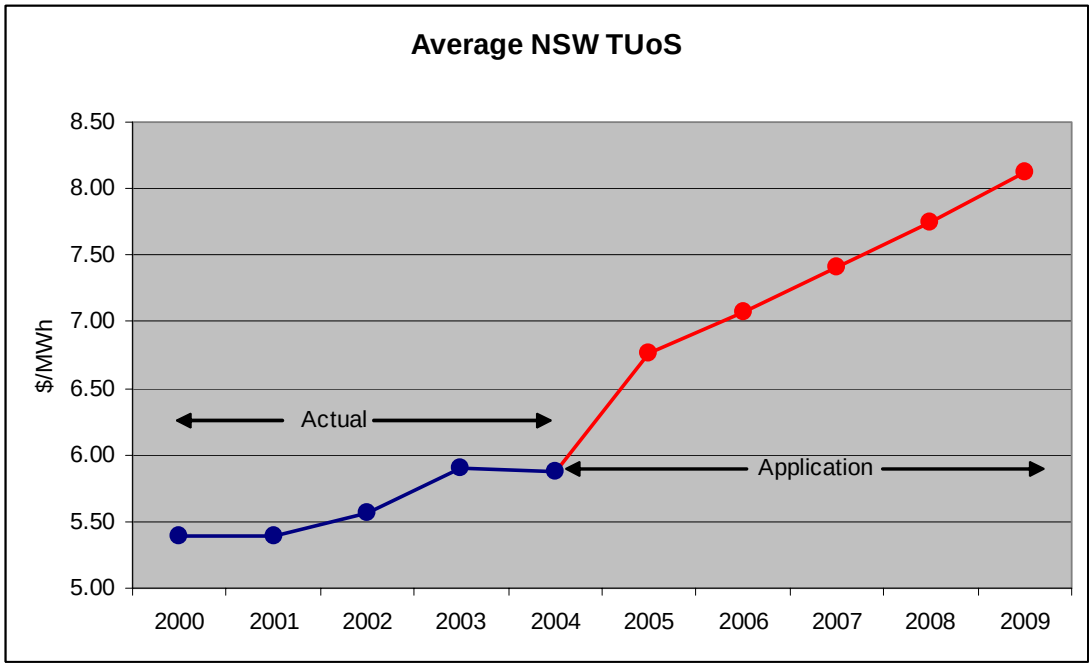
For consumers, the main impact of the ACCC's determination on this and every other transmission issue is what this application means for prices. Figure 8 shows the average transmission prices that NSW consumers pay for the delivery of electricity. Between 1999/2000 and 2003/04 under the current regulatory period consumers pay an average TUoS of between $5 and $6 per MWh at an average growth rate of around 2% pa. Under the TransGrid application the average TUoS payable will increase from $5.87/MWh to $6.77/MWh in 2004/05, a 15.3% increase in the first year of the next regulatory period. The increase will continue despite growth in energy demand[14] over the whole of the next regulatory period at an average increase of almost 5% pa. In 9 years, average TUoS prices will have increased from under $5.40/MWh to over $8.10/MWh, an increase of over 50%. Most of this increase (approximately 40%), as can be seen in Figure 8, occurs as a result of

13 Section 9.3.5.2, TransGrid 2004 Revenue Reset Application

14 Based on the GWh supplied by the TransGrid system from Table A3.1 of TransGrid's 2003 NSW Annual Planning Report.

this application. This is despite having taken into account the actual and forecast growth in energy demand over the period.

Figure 8 Average NSW TUoS Charges



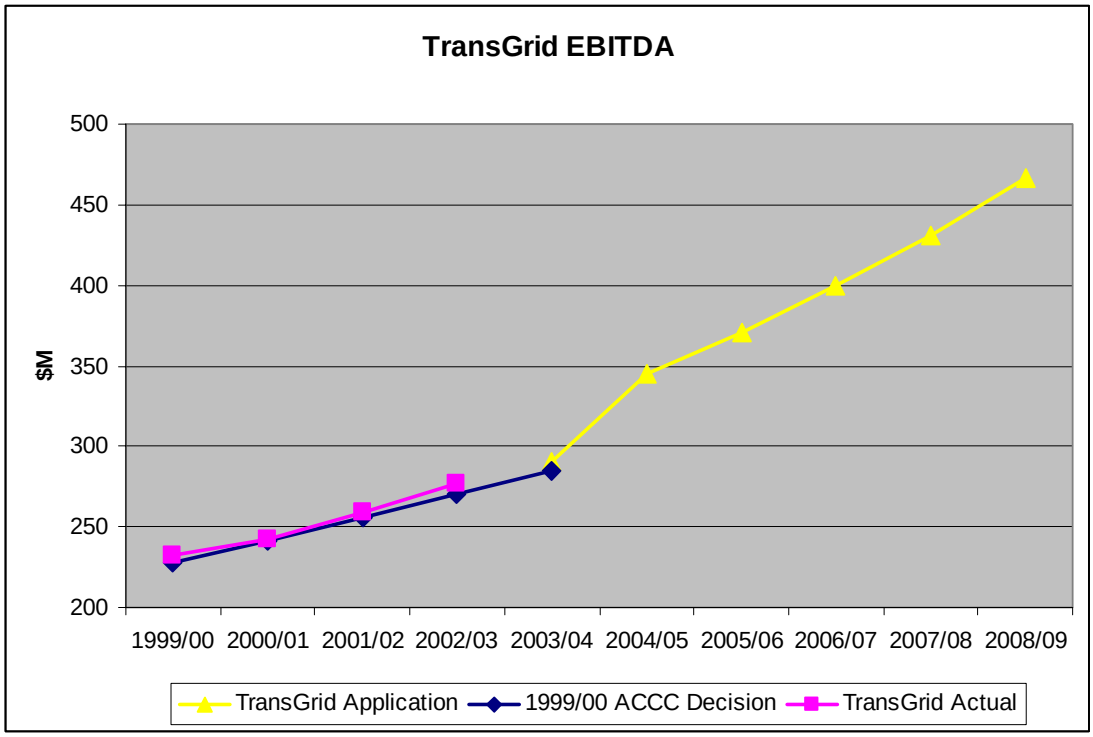
With average price increases of this order of magnitude, the ACCC must recognise the impact it would have on customers including large businesses, SME, farmers as well as domestic consumers. The adverse impact on NSW and Australian economic competitiveness when transmission prices would on average increase by over 50% must be taken into consideration in the ACCC's decision.

2.10 BUSINESS PERFORMANCE

Figure 9 shows TransGrid's profit positions. Between 1999/2000 and 2002/03, TransGrid averaged an annual operating profit before interest, tax, and depreciation of around $250M as reported in its various Annual Reports. This was in line with the average profit levels envisaged in the ACCC decision on TransGrid's revenue cap in 2000. Should its current application be approved, TransGrid's average profit over the next five years will increase by 60% to over $400M pa.

Operating profits will increase by almost 19% in the first year alone and by around 7.5% to 8.5% over the next four years. By the end of the next regulatory period, should the application be approved, TransGrid's operating profits will have increased by a massive 85% over the profits from the previous regulatory period.

Figure 9 TransGrid Operating Profit



It is difficult to envisage that an enterprise in a stable mature competitive environment can experience this level of profit growth within a 5 year period through organic growth. With this level of projected profit, there is a risk that resources will be dissipated with reduced attention to cost management just because there would be so much more room to make errors of judgement and management without adverse consequences. Figure 9 is quite strong evidence that this submission is an ambit claim.

3 ENERGYAUSTRALIA

Most of the issues relevant to the assessment of EnergyAustralia's transmission revenue requirements have already been discussed in the earlier sections relating to TransGrid's revenue. The fact that EnergyAustralia's transmission asset base amounts to little more than 10% of its total transmission and distribution asset base – and under 20% of TransGrid's transmission asset base – puts a perspective on EnergyAustralia's transmission operations.

3.1 REGULATORY ARRANGEMENTS

It seems that the current regulatory arrangement, which requires EnergyAustralia to submit applications to separate regulators for different parts of what is essentially one network, as unnecessarily bureaucratic. It is also likely to open up regulatory gaps, for example, potential "double dipping" of overhead and other operating expenses, as well as an increase in regulatory compliance costs. This is highlighted in the current case where EnergyAustralia needs two revenue submissions instead of one and both IPART and the ACCC are almost concurrently assessing EnergyAustralia's revenue requirements. It would be significantly more efficient for EnergyAustralia to be wholly regulated by IPART as a distribution network service provider with its current transmission voltage assets deemed part of its distribution network or transferred to TransGrid.

On top of this anomaly, the NSW DNSPs' regulatory arrangements are now based on average price cap rather than on total revenue cap, while TNSPs are total revenue regulated. These two forms of regulation present another complexity to EnergyAustralia, as well as other stakeholders.

3.2 REGULATORY ASSET BASE (RAB)

In its 1999/2000 decision, the ACCC provided for an opening regulatory asset base for EnergyAustralia's transmission asset of $457.4M. The ACCC also provided for a total capex of $56.7M and depreciation of 50.47M. Based on these figures, EnergyAustralia can be expected to have a closing regulatory asset base of about $464M. In its revenue application, however, EnergyAustralia claims a new ODRC valuation of its regulatory asset base of $702.1M. It seeks to justify this over 50% increase in RAB on the basis that there were

> "… significant problems with the 1999 valuation that make it an inappropriate starting point for a roll-forward for the 2004 Determination." (p 36)

As EnergyAustralia acknowledges, the original valuation was undertaken by the NSW Jurisdictional Regulator and was accepted for use during the previous regulatory determination. It is therefore inappropriate for EnergyAustralia to turn around at a

subsequent regulatory determination to seek another revaluation. If this revaluation is accepted by the ACCC, what is there to stop EnergyAustralia claiming other "significant problems with the 2004 valuation" and seek again to revalue its RAB upwards in subsequent revenue applications? Other stakeholders (customers) are unlikely to be able to justify seeking a downward revaluation of the RAB given the information asymmetry and resource availability. Accordingly any revaluation will only ever be upward to the detriment of customers. Even if customers were able to mount a case to devalue the RAB, the uncertainty created by such a move will undoubtedly be used by NSPs to seek a higher WACC to compensate for the additional risk.

As the ACCC is well aware, customer groups have always held the view that the ODRC method overstates the value of assets. It does not take into account the fact that these assets have been paid for by customers in the past and are invariably higher than any depreciated actual cost valuation. The flow-on impacts of higher than efficient asset valuations disadvantage end-use customers subject to the pressures of internationally competitive markets. However, constant revaluation also has its disadvantages with regard to the uncertainty it creates and the potential adverse impact on the cost of equity.

In its current draft determination on the NSW distribution revenue, IPART has indicated that "the Tribunal's draft decision is that it will not allow adjustments to the 1998 regulatory asset base as part of the roll forward methodology"[15]. We ask that the ACCC reach the same decision.

3.3 CAPITAL EXPENDITURE

EnergyAustralia has not provided the actual capex incurred during the current regulatory period. It is thus not possible to evaluate its historical performance against the capex allowance the ACCC provided during the 1999/2000 revenue cap decision. It is, however, abundantly clear that the current EnergyAustralia forecast capex is a few orders of magnitude greater than that approved by the ACCC previously as can be seen in Figure 10. Between 1999/00 and 2003/04, the ACCC approved a capex averaging around $11.3M pa. EnergyAustralia has forecast an average capex requirement of over $27M pa for 2004/05 to 2008/09, an increase of approximately 140%.

We estimate that EnergyAustralia's forecast capex spend over the next regulatory period amounts to over 17% of its 2003/04 RAB. This amounts to some 5 percentage points greater than TransGrid's already high relative capex spend (see Figure 3).

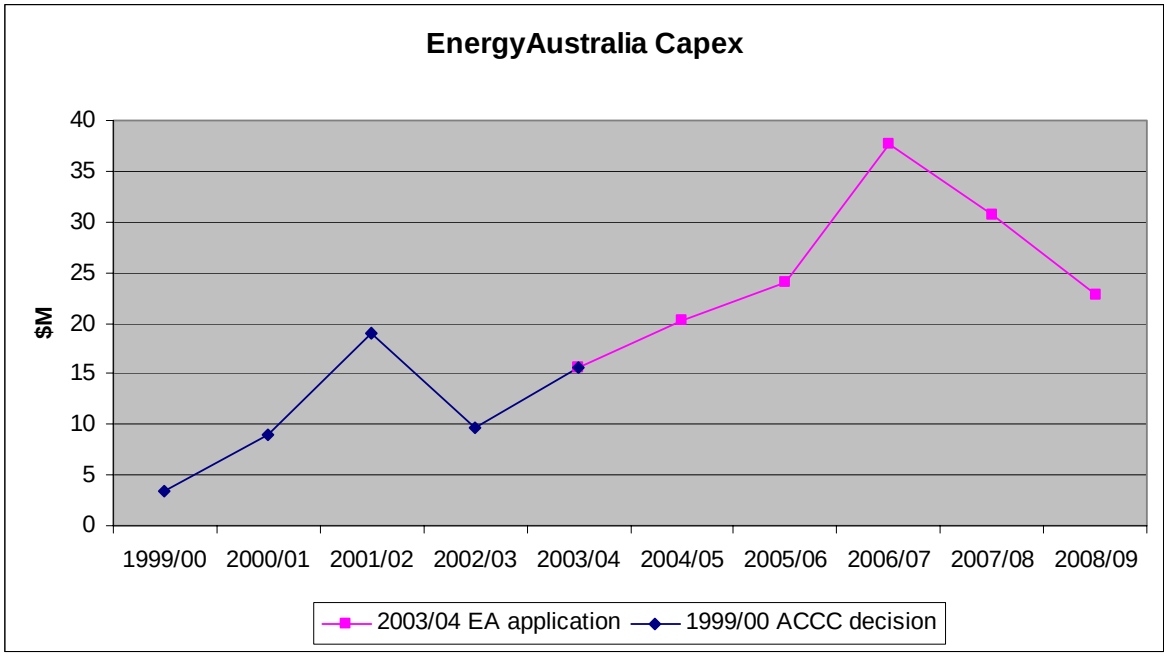
EnergyAustralia claims that the major drivers of the capex forecast are the need to:

- replace aging assets; and

[15] IPART, *NSW Electricity Distribution Pricing, 2004/05– 2008/09 – Draft Report*, January 2004 (pg 45)

- meet increased demand.

Figure 10 EnergyAustralia Capital Expenditure



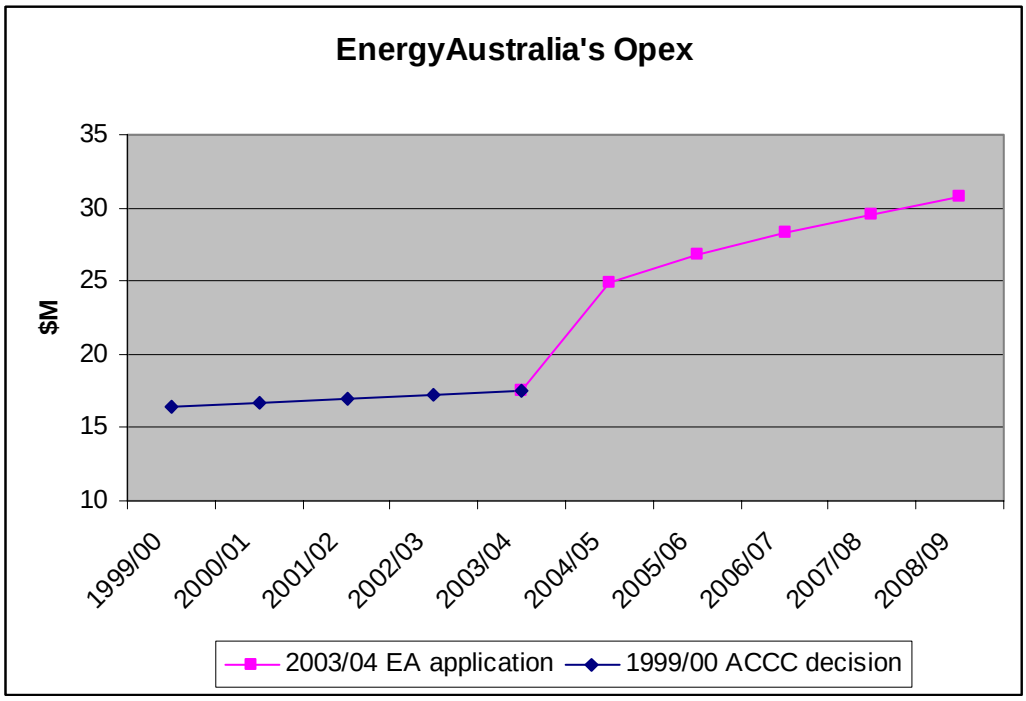
EnergyAustralia also states that there will be a trade off between replacement capital and operating expenses. Over the next regulatory period, replacement capital amounts to over $55M (almost the equivalent amount of total capex allowed under the current regulatory period). However, as can be seen in section 3.4, operating expenses have not fallen from the current regulatory period but are, in fact, forecast to increase by some 65%. Usually capex is meant to trade off opex, but this would certainly not be the case under these proposals during the next regulatory period.

As discussed in section 2.2, capital investments in network assets are a very inefficient means of meeting peak demand growth. Such growth would more efficiently be met by demand management and embedded generation. As with TransGrid, while EnergyAustralia has suggested that it encourages demand management and embedded generation responses, there are few details in its application regarding how it will do this. As mentioned in relation to TranGrid, we are concerned that the incentives facing network service providers discourages demand side response while promoting network solutions to managing peak demand growth.

3.4 OPERATING AND MAINTENANCE EXPENDITURE

EnergyAustralia's opex claim for the next regulatory period amounts to over $140M. This is a massive 65% increase over the current regulatory period. As indicated in Section 3.3, EnergyAustralia asserts that there is a "need to trade-off replacement capital and operating expenses". EnergyAustralia seems to interpret "trade-off" to mean massive increases for both capex and opex.

Figure 11 EnergyAustralia's Opex



EnergyAustralia has not provided any information on its actual opex spend on transmission assets during the current regulatory period. As such we are unable to comment on its actual performance. However, Figure 11 clearly shows the step increase in EnergyAustralia's opex forecast for the next regulatory period. This step increase amounts to some 42% in the first year alone and progressively increases by an average of 5.5%pa over the following four years so that, by the end of the next regulatory period, the level of opex would be over 80% greater than the average of the current regulatory period.

EnergyAustralia's application for opex will result in EnergyAustralia having an opex to RAB ratio of over 30%. The high opex ratio that we showed in Figure 7 for TransGrid pales into insignificance compared to this rate. By this measure, EnergyAustralia is almost five times more inefficient than TransGrid, which if its revenue application is approved, would already be the most inefficient pure TNSP in the NEM.

Our concerns (see section 3.1) about EnergyAustralia double dipping its opex, seem to be well placed.

3.5 WEIGHTED AVERAGE COST OF CAPITAL

Most of the comments made in this submission regarding TransGrid's WACC application are also applicable to EnergyAustralia. As such, it is unnecessary to repeat them in this section. The main difference in the two applications is that EnergyAustralia has a more reasonable position on the value of franking credits than TransGrid. However, we still believe that a gamma of 0.5 is overly generous to these monopolies considering the overall Australian market is 70% domestically owned.

EnergyAustralia's equity beta application of 1.06 is lower than TransGrid's application of 1.12. However, this still implies that EnergyAustralia is more risky than the whole market. Since the equity beta should reflect the businesses risk position relative to the market, an equity beta of less than one is required for a business with EnergyAustralia's relative risk profile.

3.6 COST PASS THROUGH

Like TransGrid, EnergyAustralia has applied for a cost pass through in the event of

- Cost changes which are the result of changes in statutory requirements;
- Cost changes due to unexpected or very rare and easily identifiable events; and
- Cost changes due to significant changes in (non-statutory) cost drivers.

Our response, as canvassed in section 2.7 on TransGrid's cost pass through application, is that, with the exception of cost changes due to changes in taxes (which is just a part of changes in statutory requirements), other potential changes are risks faced by all businesses which are usually unable to simply pass such costs through to their customers. These risks are already factored into the WACC allowance; otherwise the risk free rate should apply.

Already, regulated monopoly businesses do not face any risk on the revenue side of the equation. The only risks faced are cost based and even here the risks are not all negative. Moreover, with pass through of cost changes, these cost risks also disappear with consumers bearing these risks. With such a risk profile, the enterprise's equity beta should not only be less than one, but close to zero. This would bring the WACC to a level that simply reflects the risk free rate and a debt margin.

The ACCC must ensure that the level of compensation enjoyed by network service providers reflects the level of risk they carry, otherwise, the regulatory arrangement is failing Australian consumers.

3.7 ENERGYAUSTRALIA REVENUE REQUIREMENT

Figure 12 shows EnergyAustralia's revenue requirement for the next regulatory period in contrast to the maximum allowed revenue approved by the ACCC for the current regulatory period. The applied for revenue is, on average over the five years, approximately 56% higher than that for the current regulatory period.

Also shown in Figure 12 is the trend from the ACCC's 1999/00 decision forward to 2008/09. The difference between the revenue the EnergyAustralia has applied for and the trend projections amount to almost $48M, or 52%, more than consumers would be paying

based on the trend projections. The ACCC must not allow such massive increases in revenue to occur without careful scrutiny to determine prudency.

Figure 12 EnergyAustralia Revenue Requirement