

Major Employer Group (Tasmania) Submission to AER on the Transend Transmission Revised Revenue Proposal

This submission is provided to the AER in response to the AER's request for comments on the Transend Transmission Revised Revenue Proposal. The submission is structured around key issues with a number of matters raised under each of these key issues.

Global Financial Crisis and Uncertainty

Since the publication of the AER's *Transend Transmission Determination 2009–10 to 2013–14 Draft Decision* fallout from the global financial crisis has continued.

Writing in October last year, the IMF stated '*The world economy is entering a major downturn in the face of the most dangerous financial shock in mature financial markets since the 1930s.*'¹ The IMF went on to note that '*The situation is exceptionally uncertain and subject to considerable downside risks.*'²

In the *Reserve Bank of Australia Minutes of the Monetary Policy Meeting of the Board* held on 3 February 2009, it was noted 'The global slowdown was highly synchronised, suggesting a common economic shock'.³

Quarterly growth for October to December 2008 in Japan fell by 3.3% compared with growth in the same quarter in 2007, the equivalent of an annual contraction of 12.7% (Japan is a major trading partner of Australia)⁴. Similarly growth in China for the last quarter of 2008 grew at only 6.8% with reports of many millions of job losses and many more to come as growth in 2009 is forecast to be below that required to maintain employment (around 8%).

The global crisis is now clearly evident. The Australian All Ordinaries index has fallen by more than 35% this financial year. Australian unemployment is rising and the Federal Government has developed a major economic stimulus plan of approximately \$42 billion to combat the expected recession.

In the midst of this turmoil Transend appears to have largely ignored the likely effects of this economic crisis and has based its revised submission on tight labour market conditions and continuing strong economic expansion of the Tasmanian economy. This is even more surprising in the context of the fact that a very large portion of the Tasmanian electricity use is directly linked to export oriented operations.

This issue is discussed in greater detail throughout the submission.

¹ International Monetary Fund, *World Economic Outlook*, October 2008, p.xv

² International Monetary Fund, *World Economic Outlook*, October 2008, p.xv

³ RBA Minutes of the Monetary Policy Meeting of the Board, retrieved on 17 February 2009 from http://www.rba.gov.au/MonetaryPolicy/RBABoardMinutes/2009/rba_board_min_03022009.html

⁴ The New York Times online "Japan's Economy Plunges at Fastest Pace Since '74", retrieved on 17 February 2009 from http://www.nytimes.com/2009/02/16/business/worldbusiness/16yen.html?_r=1&scp=1&sq=japan%20economic%20growth%202009&st=cse

Cost Drivers

In the MEG submission in response to Transend's original Revenue Proposal it was noted that Transend claimed in several parts of the submission that the Transend cost structure is strongly affected by the predominance of hydro and increasingly by wind generation. It is also affected by the existence of Basslink. The hydro generation, wind assets and Basslink are owned and operated by Hydro Tasmania. Hence Hydro Tasmania are the cause and the beneficiary of a significant amount Transend's existing and proposed investments.

Hence as MEG recommended in its original submission the AER should review the boundaries of the prescribed transmission service taking into account the large influence of hydro and wind generation and Basslink on the operation and configuration of Transend's assets. It is our expectation that significant components of transmission assets should correctly be ascribed to and paid for by Hydro Tasmania rather than Tasmanian customers that are not direct beneficiaries of these investments.

Load Forecasts

Transend have not provided any revision to demand forecasts in their revised submission.

The original demand forecast made only modest adjustments for the introduction of the CPRS based on as we understand it quite low carbon prices. Carbon prices flow through to higher electricity prices and higher electricity prices lead to reduced demand due to income and substitution effects – so called price elasticity of electricity demand. The carbon prices forecast in the recent CPRS White Paper are higher than those considered in the Transend demand forecast. Hence the Transend demand forecast needs to be revisited with the higher carbon prices taken into account. In the event that this is not feasible then the AER should take a conservative view and remove projects that have marginal net benefits in the next regulatory period to compensate for likely lower demand than has been forecast.

The demand forecasts did not factor in the global financial crisis which will have a significant impact on Tasmanian GSP and hence growth in electricity demand. It is also likely to affect most major trading partners to which the bulk of Tasmanian electricity users are linked through mining and primary processing industries. Hence the Transend demand forecast also needs to be revisited with the global financial crisis taken into account. In the event that this is also not feasible then the AER should again take a conservative view and remove projects that have marginal net benefits in the next regulatory period to compensate for likely lower demand than has been forecast.

In summary, the Transend demand forecast is well out of date and is likely to be aggressively high once the full effect of carbon and the effect of the global financial crisis are factored in. Hence the AER should exclude all projects that have marginal net benefits as calculated by Transend as they are unlikely to eventuate in the reality that will unfold over the next regulatory period.

Capital Costs

Transend originally sought \$680.7 million of approved capital expenditure in \$2008/09 for the next regulatory period.

The AER reduced this in its Draft Decision to \$615 million of which \$55 million of the reduction was in reduced projects and \$10 million in the different application of cost indexes.

Transend's response to the Draft Decision was to provide a revised proposal with an increase over the original proposal of \$35 million to \$711 million. This is partly attributed to the now inclusion of the second Waddamana-Lindisfarne 220 kV line (previously contingent) being \$17.8 million.

In essence Transend appear to have rejected all of the proposed deferrals of asset renewals and have added in additional augmentations. All of this is in an environment in which the global financial crisis and the CPRS are unfolding making the likelihood of projects with marginal net benefits unlikely to achieve them.

Hence MEG strongly recommends that the AER reject the revised CAPEX plan put forward by Transend and reinstate the plan set out in its Draft Decision. In relation to the second Waddamana-Lindisfarne line, as it is triggered only in the last year of the regulatory period, it should be restored to a contingent project (likelihood of lower growth than forecast).

Operating Costs

Transend originally sought \$280 million \$2008/09 in operating costs over the regulatory period. The AER in its Draft Decision reduced this to \$260 million with \$14.4 million of the reduction being differences in debt and equity raising costs.

MEG concurs with the AER's view to reduce debt raising costs and disallow equity raising costs.

In relation to labour cost escalators, Transend's claim that it continues to operate in a tight market for skilled labour. This belies the environment that is unfolding as a consequence of the global financial crisis in which unemployment is expected to rise substantially over the next twelve months.

Hence MEG recommends that the AER reject the Transend claims for additional operating expenditure.

WACC

Transend claim that the risk free rate methodology will be affected by the financial crisis and that this will lead to an unreasonable bias downwards to the calculation of WACC and equity returns. It is noted that Transend did not have similar concerns when calculating WACC in the original proposal when inflationary expectations were at their peak.

Transend's proposal to use different methodologies to set inflationary expectations and the risk free rate is very much a case of not liking the outcome and thus seeking to change the rules.

The Electricity Rules prescribe a number of specific parameters in the calculation of WACC including a market risk premium of 6% and a beta of 1. These parameters are manifestly excessive for electricity transmission businesses as there is no evidence to suggest that the returns from such investments are synchronised with general movements in the market.

Appropriately geared electricity transmission investments have attributes closely associated with bonds which is why their stockholders were traditionally referred to as widows and orphans.

It is also noted that the debt risk premium in the WACC calculation provides relief in the existing tighter credit conditions. The Transend Revised Revenue Proposal uses 3.86%.

Hence there is no danger in using the current risk free rate and implied inflationary expectations, that Transend's returns would suffer to the point that it would not make investments. On the contrary the WACC formulation as it currently stands are likely to create Averch-Johnson type incentives to invest excessively in transmission assets.