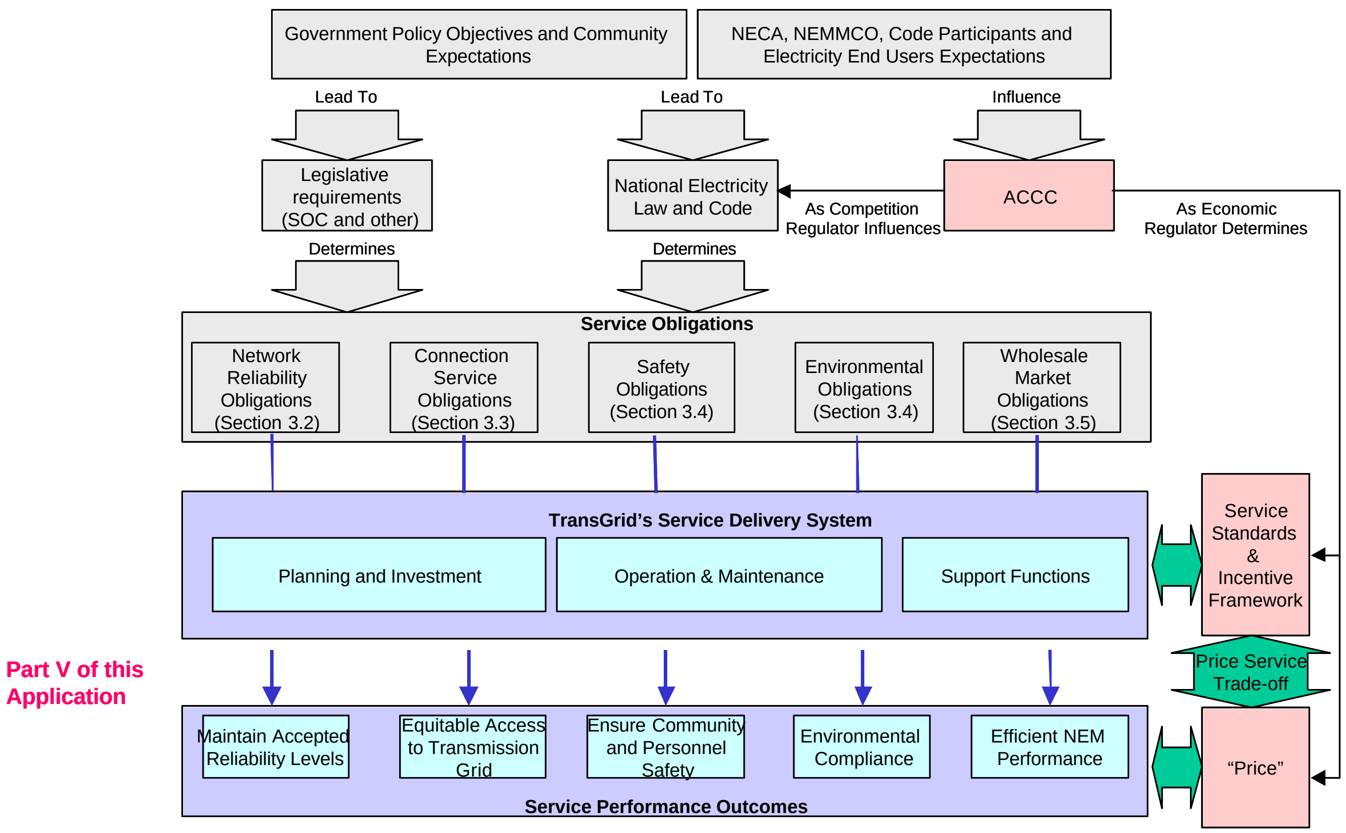
PART V:
IMPLICATIONS OF THE COMMISSION DECISION

Part V of this Application outlines the importance of the required MAR to sustain the ongoing commercial viability of TransGrid and the implications on service performance outcomes of any variation to the required MAR

There is one Chapter in this Part as follows:

- Chapter 11: Outcomes.

Figure 2-1: Framework for Business Operations and Service Delivery



11 Outcomes

11.1 Regulatory and Industry Context

TransGrid's Application regarding its revenue reset for the 2004/05-2008/09 regulatory period is being made at a particularly important juncture for the development of incentive regulation in the NEM, and more generally, in relation to the investment cycle for electricity infrastructure.

Significant elements of the regulatory framework applying to TNSPs are under review, or remain to be finalised. In particular, key areas of uncertainty relate to the following:

- The Commission's Draft Statement of Regulatory Principles is expected to be finalised in the foreseeable future, but with potentially significant refinements that will directly impact the regulatory regime faced by TransGrid.
- The Ministerial Council of Energy has now accepted establishment of an Australian Energy Regulator, but the details remain to be developed, including to what extent there may be changes to the regulatory framework.
- Some elements of the service standards incentive regime applying to TNSPs remain to be developed, such as whether or not TNSPs adjust planned outages in response to market prices.
- The Commission's review of the regulatory test for network augmentation is currently under way, and is still to be finalised. In particular, the role of the regulatory test in establishing the prudence of investment decisions and the interaction between the application of the test and the value at which assets are brought into the RAB remain to be determined.
- The recommendations from the Parer review of the energy market – much is still to be decided in terms of what, when and how these recommendations will be implemented.

While not all of these uncertainties are under the control of the Commission, the Commission's Decision will set important precedents, as it will be the first time in which a TNSP has undergone a second regulatory review by the Commission. Chapter 4 highlighted key issues that the Commission will need to address in transitioning from the current regulatory period to the next period.

TransGrid's Application is also being evaluated at a critical juncture in terms of the investment cycle for electricity assets.

An important characteristic of the energy sector when the reform process began more than ten years ago was a legacy of over-capacity and the perceived inefficiencies associated with such over capacity. Rationalisation of capital expenditure, and of the frameworks for evaluating and deciding future capital expenditure, were rightly seen to be the key to delivering efficiency gains in a highly capital intensive industry.

The existence of bountiful capacity (at all functional levels in the electricity market) has meant that there has been a degree of leeway to date for regulators seeking to apply the newly developed frameworks for economic regulation. The potential disincentives for investment arising through regulatory uncertainty in relation to the future value of investments, and through regulatory determinations that might simply be 'too tight', have been masked by the modest need for new capital expenditure.

The benefits of this legacy, however, are now becoming exhausted. In particular, the need for new investment in all parts of the electricity delivery chain are now being recognised as crucial issues going forward. The Parer review has highlighted the crucial importance of providing sufficient incentives for investment in the electricity transmission system. The current IPART review of the electricity distribution networks in NSW has similarly highlighted the need for significant investment in the distribution network in order to ensure that reliability targets continue to be met in the face of increasing demand.

This environment presents special challenges for regulators and TNSPs. In particular it means that it is more important than ever to take account of the analysis by the Productivity Commission, the Parer review and others. In order not to jeopardise the continued delivery of service obligations a stable regulatory environment and sufficient incentives for regulated businesses to undertake the new investment is required.

The Commission, in making its Decision in relation to TransGrid's revenue reset for the 2004/05-2008/09 period and in finalising its Statement of Regulatory Principles, therefore has a key role to play in ensuring that the regulatory environment supports the need for future transmission investment.

11.2 Challenges Faced by TransGrid

TransGrid faces a number of key service drivers in delivering its price-service outcomes. These service drivers have been summarised as:

- Network reliability.
- Connection service.
- Safety requirements.
- Environmental responsibilities.
- Wholesale market support.

Over the current regulatory period these service drivers have been influenced by changes in legislative requirements, including changes in the National Electricity Code. Such changes are externally driven, and include the Commission as an important player.

TransGrid is also impacted by changes in operating conditions that affect the internal business inputs needed to deliver the above objectives. A key factor is the extent of the increase in demand that it faces, as the level of demand influences the reliability performance of the transmission network.

In the current period TransGrid has managed to maintain overall levels of reliability whilst accommodating high growth in summer peak demand. This demand growth has directly influenced the detailed design of some of TransGrid's planned network augmentations. In addition, TransGrid's environmental responsibilities have also impacted expenditure outcomes.

Looking forward over the forthcoming regulatory period, strong demand growth, particularly in summer, is expected to continue. This demand growth drives the bulk of TransGrid's future Capex programme, as augmentation of capacity will be needed to ensure that TransGrid can continue to provide a safe and reliable transmission system for NSW customers.

11.3 Implications of These Challenges

The need to address the above challenges has directly shaped TransGrid's Application for its revenue reset.

Key features of the revenue reset Application, as discussed in the previous sections are:

- The need to set a precedent that rolls in all prudent Capex which has been incurred in this regulatory period, including that above the expenditure projections at the previous Decision.
- The need to fund a significant Capex programme going forward.
- Proposals to 'lock down' a more appropriate incentive framework for operating costs including improved measures of input cost movements, accommodation of exogenous costs, and a clear approach to efficiency 'carry over'.
- A significant financing task for TransGrid combined with pressure to maintain its credit rating.

Chapter 4 of this Application discussed TransGrid's capital expenditure in the current regulatory period.

TransGrid has undertaken additional Capex in this regulatory period in order to meet environmental obligations and the legitimate needs of end users, even though there has been considerable regulatory uncertainty regarding the treatment of this additional expenditure. There has been no allowance for this higher capital expenditure in TransGrid's current period MAR determination. TransGrid has undertaken the expenditure in the expectation that the Commission will roll into its asset base this additional prudent level of expenditure, and compensate TransGrid for the return it has foregone in this regulatory period in relation to this expenditure. Such an approach is considered necessary to provide incentives for regulated businesses to act efficiently in the light of changing external conditions. TransGrid believes that this needs to be a key component of the incentive regulation framework.

If the additional capital expenditure undertaken in the current period is not recognised this would put in jeopardy both TransGrid's financial position and the incentives TNSPs face to undertake efficient expenditure during the regulatory period, to address changing market needs.

In addition, the external drivers described above also underpin TransGrid's projections for the capital expenditure required going forward. Appropriate recognition of these external drivers in Capex benchmarks is required to ensure service outcomes can be maintained at current levels.

TransGrid emphasises that the position adopted by the Commission in relation to the treatment of its capital expenditure in this current regulatory period will have significant implications for the regulatory framework. In an environment where the need for investment has been highlighted, and drivers for such investment can change during the regulatory period, such signals will have important implications for the continuing achievement of required service standards.

The importance of these challenges is not to be under-estimated. Recent international experience has highlighted examples (such as the North East US and Ontario, Auckland, and California) of the severe economic impact when the integrity of electricity transmission systems is compromised. The precedents set by the Commission in response to this Application for future transmission regulation will have a significant impact on the incentives faced by transmission providers in ensuring the delivery of appropriate service outcomes including the ongoing integrity of transmission infrastructure.

11.4 Respecting the Integrity of TransGrid's Proposal

The revenue reset proposal set out in this Application has been arrived at after considerable internal analysis within TransGrid and reflects TransGrid's considered view of the minimum level of MAR which will be required in order for it to meet its service obligations over the current period. It is presented as a realistic proposal, and not as an 'opening bid' in negotiations.

As such, TransGrid urges the Commission to take a reasonable approach to its evaluation of TransGrid's proposal and, in particular, to consider the overall price-service trade-off that this proposal represents.

Commission will naturally have recourse to the advice of independent experts on the reasonableness of TransGrid's capital and operating expenditure proposals. TransGrid will welcome the opportunity to work with those experts in helping them understand our efficient business requirements.

However, the Commission should be mindful of the role of such advice in the operation of an incentive regulation regime. To the extent that strong incentives already exist for TransGrid to operate efficiently, as is the case with Opex, then the presumption should be that current levels of expenditure are already efficient. That is, the presumption should be that efficient cost levels have already been 'revealed'. In this circumstance, detailed forensic review of existing levels of Opex by the Commission may be harmful to incentive regulation to the extent that it increases the incentive to 'convince the experts' rather than to actually reduce costs. For example, TNSPs may find themselves attempting to minimise the partial benchmark indicators (eg, expenditure per km) used by independent experts rather than the actual level of expenditure.

Greater scope exists for regulatory scrutiny of capex due to the project specific nature of such expenditure, often involving economies of scale characteristics. Accordingly, Capex does not easily lend itself to incentive regulation in the same way as Opex.

In determining TransGrid's asset base, it is important that the Commission engage in a process to satisfy itself that TransGrid's past investment was efficient and prudent. Once so satisfied, the Commission must incorporate this investment in the asset base. If any part of this expenditure were excluded this would send adverse signals in relation to future investment and increase regulatory uncertainty. This is turn would be likely to directly impact the extent of future investment and/or the returns required in relation to such investment.

In relation to projected Capex, TransGrid notes that significant elements of TransGrid's proposed Capex programme for the next regulatory period will be subject to explicit scrutiny prior to the projects proceeding by means of the regulatory test for transmission augmentation. This reduces the need for the Commission to undertake a forensic analysis of this aspect of TransGrid's Application at this time.

The required cost of capital financing is a critical element driving TransGrid's MAR. TransGrid's Application has sought to put some important new perspectives on this issue. In particular, that the international CAPM cannot be presumed to produce a lower WACC than currently adopted by the Commission. In setting the WACC there is also a need to take account of the reality of a more demanding investment climate generally and the role of the WACC in ensuring that proponents exist for efficient but controversial new investments.

TransGrid's Application represents a delicate balance between the need:

- To undertake significant new investment to meet the demands of stakeholders.
- To finance this investment at reasonable cost.
- To maintain incentives to deliver these outcomes efficiently.
- To respect the interests of customers, who continue to expect value for money.

- To preserve shareholder value, and so TransGrid's corporate credit rating.

Any significant re-engineering of this delicate balance by the Commission runs significant risks that one or more of these objectives will not be able to be met.

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