TransGrid

Response to the ACCC's Draft Decision on TransGrid's 2004/05-2008/09 Revenue Caps:

Section 1 of 6

Summary

July 2004

1. SUMMARY

In addressing their respective responsibilities both TransGrid and the Australian Competition and Consumer Commission (the Commission) must both make judgements about balancing service outcomes with costs. The Commission must also make judgements about the balance between providing incentives for efficiency improvements and intervening in the operations of the business in order to achieve effective regulation. TransGrid's response to the Commission's Draft Decision on TransGrid's 2004/05 to 2008/09 Revenue Caps has been prepared with both these considerations in mind.

In reviewing TransGrid's response to the Commission's draft Revenue cap decision, TransGrid asks the Commission to objectively and responsibly consider:

- The very real challenges faced by TransGrid over the next 5 years and beyond in maintaining an appropriate level of network reliability within NSW, while continuing to support competitive trading in the wider National Electricity Market.

- The need for TransGrid to deliver sustainable outcomes, having regard for the trade-off between short term cost reductions and longer term service implications. Among other matters, TransGrid faces specific challenges in maintaining a suitably skilled core workforce at reasonable cost due to labour market cost pressures and a substantial proportion of its core skill base approaching retirement.

- Very real evidence that TransGrid has been, and remains, focussed on efficiency improvements, having regard for the crucial balance between cost and service outcomes.

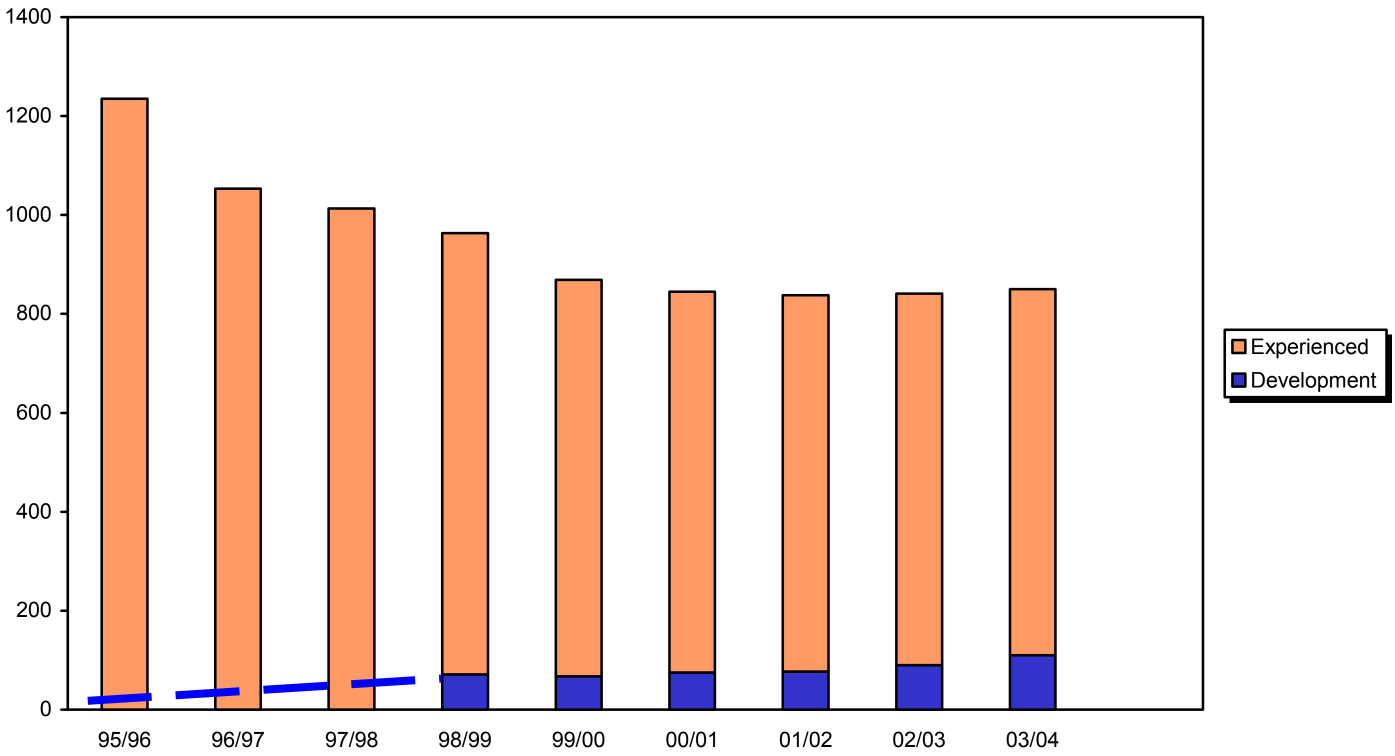
- The need for some increase in transmission prices in order to accommodate essential and pressing investment, as well as organic growth in the operating side of TransGrid's business.

In terms of the challenges facing TransGrid, the most obvious is the pressing need for significant network developments, supplemented where appropriate, by demand side management and generator support agreements, over the next regulatory period, simply to 'keep the lights on'. These developments include reinforcing the main backbone network capability to enable NSW and interstate generation to match the growing demand in NSW, as well as continuing the development of the Sydney area network to ensure adequate reliability for this vital load.

Significantly, TransGrid has provided information to the Commission and its consultants, GHD, showing very real achievements in efficiency improvements since

TransGrid's formation in 1995. Specifically, operating costs have been reduced by at least 25%, and operating staff levels have fallen by almost 40%, since that time. Service levels have been maintained or improved over the same period. In short, TransGrid has a demonstrated commitment to improving operating efficiency and is coming off an efficient base coming into the next reset period. This is explained further in Section 2 of this submission and is particularly relevant to the operating expenditure targets proposed by the Commission.

Figure 1



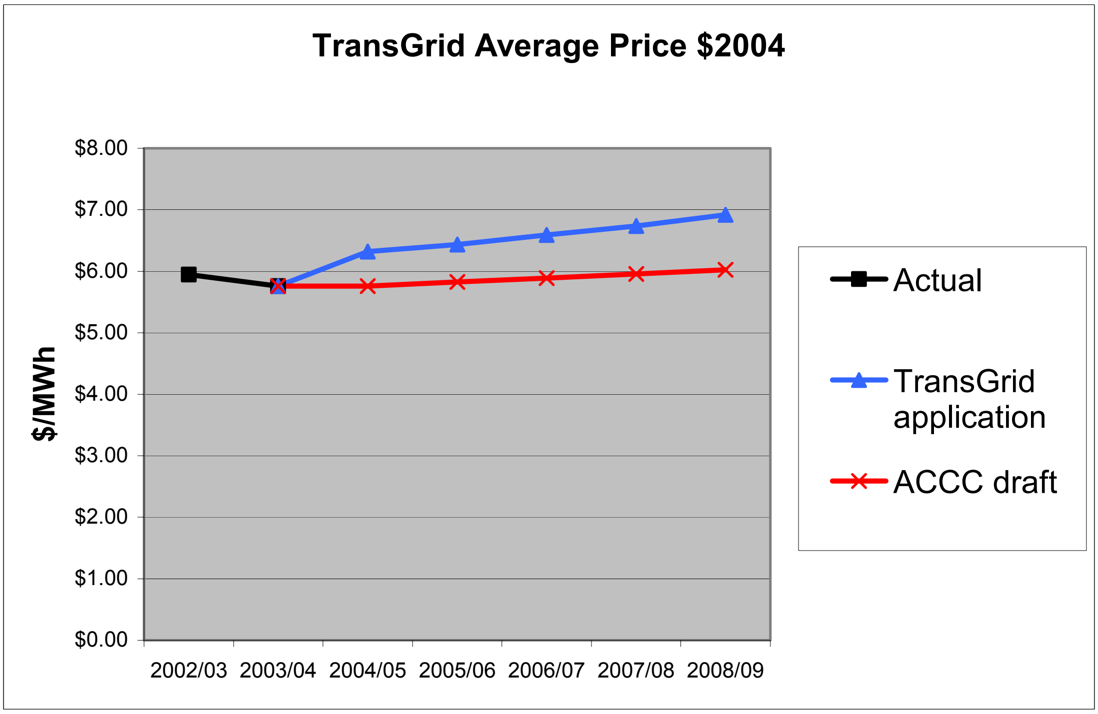
Referring to Figure 1 above it is worth observing that, in recent years, TransGrid's operating staff levels have been relatively constant. In line with information previously provided to the Commission and their consultants, GHD, this has been a deliberate strategic objective over this past period and into the next reset period. It is TransGrid's assessment that this achieves an appropriate balance between efficiency gains and sustainable service outcomes.

The efficiency gain arises from the increase in new service obligations, and asset base managed by these staff over the past period, as well as to support substantial development of network capability over the next reset period. Importantly, there has been a concurrent increase in training positions, at the expense of more experienced staff, in line with the need to ensure a sustainable level of core skilled staff as a disproportionate number of experienced and critical specialised staff reach retirement age. The relative reduction in experienced staff has been possible because of the improved productivity of a smaller pool of remaining experienced staff.

With regard to transmission charges, some impact is necessary, and we believe, acceptable to end users, having regard for the level of investment and asset management needed to underpin a high performance essential service, and the very modest impact of transmission charges on end use electricity charges. TransGrid also notes that transmission charges in NSW are coming off a very low base, as set out clearly in TransGrid's revenue cap application.

It is important that the Commission, in representing these price impacts includes all the factors. In this regard the impact of TransGrid's original revenue application on transmission charges needs to be expressly adjusted for the acquisition of Snowy assets. While this is a real impost on customers it represents the outcome of a previous revenue cap decision by the Commission and should not be included as an impact arising from the current revenue cap decision. TransGrid would appreciate it if information provided by the Commission on its website or other publications either did not include this impact, or explicitly and transparently quantified this impact. Figure 2 below shows the transmission price outcomes after adjusting for the Snowy assets (but without further reductions associated with re-allocation of market settlement residues and residue auction proceeds).

Figure 2



<u>Note</u>: All dollars in *Figure 2* above are in 2004 dollars

Specifically, in relation to the Commission's draft decision TransGrid has set out the adjustments proposed for the Commission to consider in reaching its final decision. Details of these adjustments are set out in Sections 2 to 6 of this submission and summarised as follows.

Section 2 – Operating expenditure targets.

TransGrid believes that the Commission should adopt 2003/04 actual operating expenditure levels as the appropriate starting point for its calculations when audited values become available and with appropriate adjustments for temporal factors.

However, should the Commission wish to retain its approach of basing the starting point on 2002/03 actual operating expenditure levels, TransGrid proposes the following adjustments to the Commission's draft determination:

- Labour related cost increases should be forecast at 5.0% p.a., in line with actual labour market conditions not 4.1% p.a.;
- The costs to TransGrid of maintaining new assets should be included in projections;
- Reinstatement of the $1.55m from 2002/03 incorrectly removed insurance premiums;
- Cost changes in the two years 2002/03 to 2003/04 and 2007/08 to 2008/09 should be modelled on the basis of cost indices accepted by the Commission in other parts of the draft determination rather than CPI; and
- The Commission's explicit 2% efficiency target needs to be adjusted to compensate for other implicit efficiencies, to reflect a more complete assessment of the true scope for efficiency gains, to accommodate the consequential costs associated with implementing these targets, and to enable TransGrid to share equitably (as required by the Code) in both explicit and implicit efficiency gains.

The table 1 below sets out the effect of these proposed changes on TransGrid's allowable operating and maintenance expenditure over the next regulatory period.

Table 1

	03/04	04/05	05/06	06/07	07/08	08/09
TransGrid's estimated operating expenditure (real 2003/04 $m)	118.4	123.4	125.9	128.7	132.2	135.2
Commission Draft Decision (real 2003/04 $m)	114.4	115.4	114.6	113.9	113.3	111.1

(Note that, for the purpose of comparison TransGrid has not included the costs of self-insuring Towers and Wires risk in the above table 1 (as this was not included in the Commission's draft decision on the basis that the TransGrid was to provide a copy of the relevant Board resolution). However, in the final decision, now that the relevant Board resolution has been provided, the Commission should also include an amount of $0.755m in 2003/04 dollars to reflect this amount.)

Before adopting an explicit efficiency target the Commission needs to undertake significantly more analysis (and explanation) of where TransGrid can achieve these efficiencies. However, if the Commission is to impose such a target:

- it should only be applied to controllable costs (eg, not to costs driven by external factors such as insurance and taxes nor to costs the Commission has separately determined as efficient – eg debt raising costs and self-insurance of Tower's and Wires risks);

- it should be set at a level to allow a fair sharing of the benefits (as required by the Code) between TransGrid and customers; and

- it should not exceed the average efficiency levels in the Australian economy. In effect this would require that the Commission's only efficiency adjustment be to escalate wages by CPI rather than nominal wage growth. (To be clear, this means that the Commission would remove the 2% efficiency target altogether in favour of indexing labour related input costs at CPI rather than nominal wage growth. This, of itself, imposes an economy wide average level efficiency improvement target on TransGrid's operating costs. Further adjustments are also needed to address the above comments on adjustments to controllable costs and equitable sharing of efficiency gains.)

Section 3 – Optimisation of 500kV Assets.

The Commission's draft decision in relation to TransGrid's 500kV assets is, in effect, to exclude $70 million of re-optimised value from the regulated asset base for both the current regulatory period and future regulatory periods. This decision clearly has a material financial impact on TransGrid and it is important for the transparency of the regulatory process to be accompanied by an intellectually sound rationale.

To assist in the Commission's assessment of this matter TransGrid has reviewed the relevant facts and has come to the following four key conclusions:

- Aspects of the Commission's current interpretation of the previous TransGrid (2000) Revenue Decision on this matter need to be reassessed. Specifically, operation or otherwise of an asset at its design voltage is not the essential consideration in assessing whether there has been a change in the service level of that asset.

- The Bayswater-Mt Piper and Mt Piper-Marulan 500 kV lines (the Bayswater line) should not be excluded from TransGrid's asset base under any reasonable interpretation of the optimisation regime applying to TransGrid.

- If the optimised value relating to the 500kV assets is brought back into the RAB in the future, the draft Statement of Regulatory Principles (SORP) requires the roll-forward of the optimised value at TransGrid's WACC. This has the affect of leaving customers essentially no better off than leaving the asset in TransGrid's current asset base. That is, removing the value of 500kV assets from TransGrid's asset base creates costs and complexity that serves no substantive purpose.

- If the Commission remains of the view that operation at 500kV is the determining consideration for bringing the value of the 500kV assets into the RAB then this will almost certainly arise during the 2005 to 2009 regulatory period. As a matter of proper process TransGrid would expect the Commission's position on this be clearly set out in the final decision to ensure that there is no confusion about such treatment in the future.

Section 4 – MetroGrid.

The approach adopted by the Commission to calculate a prudency adjustment is not consistent with the requirements of the Code and the Commission's own Statement of Regulatory Principles. Accordingly, there is insufficient basis for excluding any of the capital expenditure, or associated returns on investment, resulting from the MetroGrid project from being rolled into the Regulatory Asset Base.

The approach adopted by Mountain Associates of attempting to estimate the costs which would have been incurred by a prudent operator acting in accordance with good industry practice, is sound. However, some of the conclusions drawn by Mountain Associates, particularly that the project could have been delayed with the assistance of Demand Side Management, are incorrect.

Once the errors in the Mountain Associates report are corrected, it supports TransGrid's position that TransGrid's expenditure on the MetroGrid project is prudent.

Section 5 – TransGrid's Regulated Rate of Return.

The Commission's approach to setting the debt margin is biased downwards in two important respects. TransGrid recommends the Commission amend their final decision to remove these biases by:

- Adding 18 basis points to the cost of debt on the basis of Professor Grundy's conservative estimate of the bias inherent in CBASpectrum's estimation technique for long dated bonds; and

- Adding around 9 basis points to the costs of debt as a result of adopting an A-credit rating rather than an A credit rating (based on CBA Spectrum reported differential in yields between A and A- corporate bonds on 2 July 2004).

In addition, around 3 basis points needs to be added to the real risk free rate (and around 9 basis points to the nominal risk free rate) used in the draft decision to convert the yield quoting convention to a compounded yield over a single 12 month period.

Section 6 – 'Pass throughs', Service Standards and Other Matters.

1. TransGrid is seeking to have specific foreseeable material operating expenditure increases, that are outside TransGrid's control, and that are triggered by events in the past regulatory period, which result in material levels of expenditure in the 2004 to 2009 regulatory period, included as operating expenditure 'pass throughs'.

2. In relation to Service Standard targets TransGrid is requesting:

   - Clarification of Average Outage Time Restoration measures

   - A transformer availability target that is achievable and involves a more symmetric cap and collar incentive regime than proposed by consultants, GHD. Specifically, a target of 99.0%, with a cap of 99.5% and a collar of 98.7% is being sought.

3. The removal of capital expenditure associated with the provision of the Kempsey to Coffs Harbour line from TransGrid's Regulatory Asset Base is unjustified and based on a misunderstanding of the arrangements for provision of this line involving Country Energy and the local community.

4. Disallowing TransGrid's claim for the inclusion of benchmarked equity raising costs in TransGrid's revenue cap reflects inconsistent regulatory treatment and is contrary to principles of competitive neutrality.