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

Section 6 of 6

'Pass Throughs', Service Standards and Other Matters

July 2004

6 'PASS THROUGHS', SERVICE STANDARDS AND OTHER MATTERS

This Section of the Response to the Commission's draft revenue decision addresses a number of different areas:

- Operating expenditure 'pass throughs':
    - General Considerations
    - Demand side management payments
    - New Land Tax Requirements
    - NEMMCO Communication Standards
- Service standards
- Equity raising costs
- Adjustments to past capital expenditure
- Treatment of South Australia – NSW Interconnector (SNI) costs

These matters are discussed in turn.

6.1 Operating Expenditure 'Pass Throughs'

In its Application TransGrid proposed eight cost pass through categories relating to costs that TransGrid considered to be essentially uncontrollable by nature and therefore cannot be subject to the same incentive measures as the majority of TransGrid's expenditures. The Commission in its draft decision has approved pass throughs for the following categories:

- A change in taxes event
- A services standard event
- A terrorist event
- An insurance event
- Grid support payments.

TransGrid notes that the Commission will be addressing the precise wording of the pass through rules as part of the process to complete the final decision. In this regard TransGrid will be pleased to work with the Commission to finalise these arrangements. As part of this work TransGrid will assist the Commission to establish the pass through rules that should be applied, including:

- Identification and treatment of additional pass through events that may arise subsequent to the final decision
- Initiation of pass through
- Notice of proposed pass through
- Supporting information
- Determination by the Commission on the pass through amount
- Relevant factors to be taken into consideration by the Commission to ensure that the impact on TransGrid associated with a pass through event is financially neutral
- Assessment period

TransGrid wishes to notify the Commission that a number of potential pass through events have arisen since TransGrid submitted its Application to the Commission. These pass throughs relate to events that have already occurred or will be in effect from 1 July 2004 and are expected to have a material impact on TransGrid's expenditure during the 2004 to 2009 regulatory period. For example:

- Demand side management payments
- New Land Tax Requirements
- NEMMCO Communication Standards

Each of these is explained in turn and the Commission's approval is sought for them to be treated as an operating cost 'pass through' in the regulatory period.

6.1.1 Demand Side Management Payments

As part of approval of TransGrid's MetroGrid Project (TransGrid - 330kV Underground Electricity Cable - Picnic Point to Haymarket, approved 5th March 2002), the NSW Department of Planning (now Department of Infrastructure Planning and Natural Resources

- DIPNR) imposed a number of "Conditions of Consent". Of these Conditions of Consent, Conditions 26 to 37 required establishment of a Special Purpose Fund with contributions by TransGrid and Energy Australia of $1 million per year each over a period of 5 years. A copy of the relevant Conditions of Consent is attached (Appendix 6A).

The sole objective of the Special Purpose Fund is to meet the Conditions 26 to 37 of the Conditions of Consent applying to the approval of the MetroGrid Project through underwriting a programme of activities in demand management and environmental and social impacts of providing additional electricity supplies to the inner Sydney Region.

The Fund is administered by a Management Committee Chaired by DIPNR and one representative each from TransGrid and Energy Australia.

As this is a regulatory requirement outside of TransGrid's immediate control the Commission is asked to include recognition of this event as eligible for treatment as a Service Standard Event operating cost 'pass through' in the final revenue decision. TransGrid would be pleased to provide the necessary information to validate the costs involved in each year of the regulatory period.

6.1.2 New Land Tax Requirements

Under New South Wales Legislation, The Land Tax Management Act, TransGrid is responsible for payment of land tax on all lands owned as at 31st December in a given year. On 7 May 2004, the NSW Government introduced legislation to vary the methodology for calculation of Land Tax. While the decision date for the increased liability occurred in the 1999 to 2004 regulatory period, the new legislation will create a material additional increase in taxation liability for TransGrid over the 2004 to 2009 regulatory period. As this is outside of TransGrid's immediate control the Commission is asked to include recognition of this event as eligible for treatment as a Taxation Event operating cost 'pass through' in the final revenue decision. TransGrid would be pleased to provide the necessary information to validate the costs involved.

6.1.3 NEMMCO Communication Standards

The Power System Data Communications Standard, produced by NEMMCO as part of its Code obligations, came into force on 1 January 2004. The Standard imposes a number of data communication service performance obligations on TNSPs in relation to, inter alia, update time, down time and circuit availability. This is expected to impose a range of new requirements and associated costs over the regulatory period.

By way of specific example the existing communications network in the north of NSW does not allow the unavailability requirements of the Standard to be met for the existing Lismore and future Coffs Harbour 330/132 kV substations.

Similarly, it is considered that without the provision of a diverse route for the telecommunications network between Sydney and Dumaresq, and around the Sydney Metropolitan area, the existing communications network will not meet the circuit unavailability requirements.

In addition, it is anticipated that augmentation of the southern communications network may be required to satisfy the requirements of the Standard. Investigations are continuing.

Analysis of the options for the north of the state has been undertaken, but that for the central and southern areas has not yet been completed.

For the north of the state, it is considered that the most cost-effective way to meet the requirement of the Standard would be to establish a microwave radio network with low-capacity radio spurs to service the substations of interest.

A number of options, with initial capital costs up to $12 million were investigated. The preferred option involves early capital expenditure of about $4 million and annual operation and maintenance costs of around $1.5 million.

It is anticipated that to meet the requirements of the Standard in the central and southern regions, additional capital expenditure of around $8 million to $10 million (with associated annual operation and maintenance cost of around $1 million each) will be required.

Future capital estimates for the works will be included in schedules to be submitted to the Commission by TransGrid later this year as part of the process for setting TransGrid's regulatory capital expenditure cap.

However, operation and maintenance costs have not been included in TransGrid's submission to the Commission to date. As this is a material cost increase, outside of TransGrid's immediate control, the Commission is asked to include recognition of this event, and other material additional operating costs arising from the new NEMMCO Communication Standards as eligible for treatment as a Service Standard event operating cost 'pass through' in the final revenue decision. TransGrid would be pleased to provide the necessary information to validate the costs involved as they arise.

6.2 Service Standards

6.2.1 Average Outage Restoration Time

Reference is made to the following statement in the draft Decision:

> *"GHD notes that the cap proposed by TransGrid aligns closely with the Service Standards Guidelines, exposing ± 1 per cent of its maximum allowable revenue (MAR) at risk. However, TransGrid proposed a cap of 7 days for any single event impacting upon the average outage duration. This differs from the Service Standards Guidelines, which nominated that single events be capped at 14 days. However, GHD considers that using a 7-day cap for single outage events provides sufficient flexibility to set a reasonable target, cap, collar and deadband, and thus enables it to set a sound incentive scheme for this outage measure."*

While TransGrid agrees with GHD's observation about the flexibility provided by a 7-day cap and its setting a sound incentive scheme for this measure, TransGrid would correct the impression that it has deviated from the Guidelines.

TransGrid has always proposed a 7-day cap (with a 1500 minute target) as its preferred option in establishing service standards. In its response of November 2002, TransGrid provided additional historical data with a cap of 14 days (and also uncapped) to demonstrate the increased volatility of the measure with caps higher than 7 days. It re-iterated is proposal of a 7-day cap.

However, in the Guidelines issued in November 2003, Commission retained the 14-day cap for TransGrid but nominated a 7-day cap, for the same measure, for Powerlink. This unsupported inconsistency suggests that the Guidelines contained an internal error and a cap of 7 days for TransGrid was appropriate to be consistent with that for Powerlink.

Notwithstanding the need to clarify that TransGrid's position is in line with the Guidelines, GHD's recommendation to use a 7-day cap is supported.

6.2.2 Average Outage Restoration Time

TransGrid proposed a 7-day cap instead of the 14-day cap outlined by SKM and the Commission's Service Standards Guidelines, stating that its annual target of 1500 minutes is firmly linked to the 7-day cap. The Commission's consultant, GHD, states that the implications of this proposed variation are that all events that cause outages within the 7 and 14-day range would be incorporated into the measure as 7 day events, the target that it has set should allow for this. Specifically:

> *"GHD's analysis of TransGrid's historic performance with regards to the Average Outage Restoration Time with a 7-day cap per event found that half of the results lie within the deadband set for this measure. If the proposed service standard for this measure were applied over the six years of available data, TransGrid would have returned a total bonus of 0.125 per cent of MAR."*

As stated in its comments on 6.2.1 above, the Guidelines inappropriately nominated a 14-day cap for TransGrid's measure. GHD's comment that *"…all events that cause outages within the 7 and 14-day range would be incorporated into the measure as 7 day events, the target that it has set should allow for this"* is open to misinterpretation. i.e. it is possible for a third party to read this as "should allow for this (but doesn't.)

TransGrid categorically affirms that in calculating its set target of 1500 minutes (for events capped at 7 days) that all outages, both within the 7 to 14 day range and longer than 14 days, have been capped at 7 days and included. GHD's comment should be amended to read "…does allow for this."

6.2.3 Suggested Performance Incentive Scheme

On page 112 of the Commission's draft decision, the details appear to be taken from GHD's Draft report, not GHD's Final Report. Table 8.5 appears to be from GHD's Final Report and has been explicitly adopted by the Commission for the purposes of the draft decision. To avoid confusion it would be appropriate to align the details on page 112 with Table 8.5.

In addition, on page 154, **Figure 5.5 – Financial incentive curve – reliability events (> 0.04 (sic) system minutes)** appears to be incorrect, showing the same cap/target/collar as for the > 0.05 system minutes measure. The correct chart for >0.4 should be shown.

6.2.4 Table 8.5 : Transformer Availability

GHD and Commission propose that the Transformer Availability Cap be raised from TransGrid's proposed 99.5% to 99.7%. TransGrid submits that there is no cogent reason for this and results in an unreasonably large gap between Target and Cap. For example, the gap between Transformer Collar and Target (0.8%) and Transformer target and Cap (0.7%) are virtually identical (non-skewed) while the equivalent gaps for Transmission Line and Reactive Plant Availability are 0.5%/0.2% and 1.6%/0.7% respectively contain appropriate levels of skew for the measures.

In addition, 99.7% sets the Cap at a level which cannot be achieved when carrying out all policy mandated maintenance.

For these reasons, TransGrid maintains that its proposed cap of 99.5% be maintained, while retaining GHD's proposed values of Target (99.0%) and Collar (98.2%).

6.2.5 Commission's Considerations re: Average Outage Restoration Time.

Referring again to the Commission's draft decision:

> *"TransGrid has proposed a 7 Day cap instead of the 14 day cap on outage restoration time, with an annual target of 1500 system minutes. The ACCC understands that by not using the 14-day measure that was outlined by SKM and incorporated into the Service Standards Guidelines, the outage events that could occur between 7 and 14 days would not be caught by TransGrid's proposed target. If 1500 system minutes is the annual average outage restoration time associated with a 14 day cap, then a lower annual average target is appropriate for a 7 day cap. The ACCC believes that the outage restoration targets recommended by GHD are appropriate."*

TransGrid submits that the above paragraph is both internally inconsistent and misleading. As indicated above, TransGrid categorically affirms that in calculating its set target of 1500 minutes (for events capped at 7 days) that all outages, both within the 7 to 14 day range and longer than 14 days, have been capped at 7 days and included.

Commission's understanding *"that by not using the 14-day measure that was outlined by SKM and incorporated into the Service Standards Guidelines, the outage events that could occur between 7 and 14 days would not be caught by TransGrid's proposed target"* is erroneous. All such events are captured in the calculation of the target value and the ongoing calculation of the measure.

"If 1500 system minutes is the annual average outage restoration time associated with a 14 day cap, then a lower annual average target is appropriate for a 7 day cap" is also factually incorrect. The value of 1500 minutes was the calculated annual outage restoration time associated with a 7-day cap. The equivalent value for a 14-day cap was significantly higher. Hence, a lower (than 1500) target value would NOT be appropriate for a 7-day cap.

However, Commission's final sentence *"The ACCC believes that the outage restoration targets recommended by GHD are appropriate"* is appropriate as GHD recommend a 7-day cap target of 1500 minutes.

TransGrid requests that this whole paragraph we rewritten to reflect the correct facts about the 7-day cap and target value of 1500 minutes.

6.3 Adjustments to Past Capital Expenditure - Coffs Harbour to Kempsey Line

6.3.1 Selection of the most appropriate option

In evaluating the Coffs Harbour – Kempsey Transmission Line, all of the projects subjected to economic evaluation were network options. Generation options were not available due to the absence of suitable fuel sources in the area and demand side management was assessed by an independent consultant SRCI as being ineffective in relieving the constraint.

In respect to effect of movements in costs impacting on the ranking of the options:

- All of the network options involved the construction of a transmission line from Coffs Harbour to Kempsey accompanied by various substation works;
- For all of the options implementation would have been provided by TransGrid engaging experienced contractors via a competitive tender process; and
- All of the options would have involved the acquisition of easements in the same vicinity as the constructed option.

It is likely that all options would have been exposed to the same exogenous events and there would have been minimal impact on the ranking of the options.

In addition, the community had expressed a strong preference for redevelopment of the existing 66 kV line between Coffs Harbour and Kempsey. As the Commission is aware economic analysis must take into account non-quantifiable factors. TransGrid conducted an extensive community consultation process and has given significant weighting to the preference expressed by the community for the redevelopment of the existing line.

TransGrid believes the correct project from an economic perspective has been implemented.

6.3.2 "Doubling Counting" of Asset Value

TransGrid constructed the line on the route of the former Country Energy 66 kV line. TransGrid agreed with Country Energy that customers would:

- continue to receive distribution network services from Country Energy;
- be no worse off in terms of distribution services delivered following the construction of the line; and

- distribution service charges would not be increased as a consequence of the project.

To achieve this:

- TransGrid constructed a double circuit line on the route of Country Energy's former 66 kV line;
- Country Energy maintained in its regulated asset base the value of the former 66 kV line;
- Country Energy continued to deliver the distribution service and based its charges on a consistent and unchanged asset value contained in its regulated asset base; and
- TransGrid would roll into its regulated asset base the actual cost of construction of the double circuit construction.

As TransGrid did not purchase the 66 kV line from County Energy, the total cost of the Coffs Harbour to Kempsey double circuit line only includes the cost to provide a 132 kV double circuit line in the manner overwhelmingly supported by the community.

Doubling counting has not occurred as TransGrid did not purchase the 66kV line from Country Energy. Had it done so then the construction cost would have risen by the purchase price, and TransGrid would have been able to seek to apply charges for the delivery of distribution services from the 66kV circuit.

6.3.3 Conclusion

It is considered that the Commission cannot justify a reduction of the cost of the "conductors" used by Country Energy on this line being excluded from TransGrid's Regulatory Asset Base.

6.4 Equity raising costs

TransGrid is concerned that the Commission's treatment of equity raising costs over time has been inconsistent and at odds with its own publicly stated principles. In the Discussion Paper on the Draft Statement of Regulatory Principles, published in August 2003, the Commission said (at page 85):

> *As with debt raising costs, the Commission considered it was appropriate to provide a benchmark allowance for equity raising costs in recent decisions. In 2002, the Commission researched equity raising costs and in particular collected the latest information about equity raising costs for several major Australian infrastructure equity raisings. The equity raising costs generally fell between 2.10 and 5.77 % of total equity raised.*

The Commission concluded its discussion with a statement to the effect that the Commission's preferred position was *"to maintain its approach to provide for equity raising costs"*.

In practice, however, the Commission has not applied this principle consistently. In the revenue cap decisions for SPI Power Net and ElectraNet, the Commission has expressed the view that a benchmark allowance for equity raising costs was appropriate when equity raising costs must be paid by an entity raising capital. In the decision for Transend, and the draft decision for TransGrid, the Commission did not allow equity raising costs because it considered that a Transend and TransGrid were unlikely to incur these costs.

Putting aside the issue of lack of consistency with stated principles (and the resulting lack of certainty to TNSPs), the Commission's decisions have resulted in a situation where publicly owned companies have been denied an allowance for equity raising costs while privately owned companies have not. TransGrid submits that this approach is, as a matter of principle, at odds with the principles of competitive neutrality. Competitive neutrality requires that companies not be disadvantaged by reason of their ownership structure. In this case, publicly owned companies have been disadvantaged because they are denied the allowance that could allow them to access private sources of capital. The effect of the Commission's decision is to privilege private ownership of transmission assets. TransGrid submits that this is neither justifiable from an economic point of view nor consistent with good regulatory practice.

6.5 Treatment of South Australia – NSW Interconnector (SNI) costs

TransGrid notes from page 67 of the draft Decision that the Commission is considering whether the costs associated with SNI should now be treated as capital or operating costs, in the event that this project (as now seems most likely) does not proceed.

From an accounting perspective, costs associated with capital projects that do not proceed to completion (for example the costs of option feasibility assessments that show that a particular project is not economic) are usually treated as operating costs. Adopting a similar treatment for regulatory purposes would assist in preserving some alignment between financial (audited) and regulatory accounts. For this reason, this is the approach preferred by TransGrid.

However, TransGrid acknowledges that there are price smoothing benefits in recognising this expenditure as capital expenditure and rolling it into the Regulatory Asset Base. This outcome would also be acceptable.

6.6 Summary

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.

APPENDIX 6A – Demand Side Management Payments: Relevant Conditions of Consent for MetroGrid Project

1. The Proponent is to contribute to a special purpose fund, in partnership with TransGrid / EnergyAustralia, to underwrite a programme of activities to offset the environmental and social impacts of providing additional electricity supplies to the inner Sydney Region, by investigating the potential for reducing the demand for electricity by all classes of consumers.

2. The fund will receive a total injection of $10m over a period of five years, split equally between the two contributors.

3. The fund will be established and supported by the Director-General. It will be managed by a Committee comprising a nominee of the Director-General and a representative from each of the Proponent and TransGrid. The region covered by the fund will be the distribution sector of the Sydney region generally supplied from the interconnected network between TransGrid's Sydney North, Sydney South and Beaconsfield substations.

4. The Management Committee will produce guidelines describing how the fund will operate and be administered and submit these for approval by the Director-General, who may also approve variations to it on the advice of the Committee. The guidelines will include provisions for independent auditing to ensure transparency and the prudent disposition of the funds in achieving the required outcomes.

5. A report on the activities supported by the fund and its administration will be prepared and made publicly available at the end of each financial year.

6. The activities to be supported by the fund are to include, but not be limited to:

   Preparing an inventory of the existing standby generation facilities in public and private sector premises in the CBD and inner Sydney region that may be suitable for supplementing the supply of electricity in the network. The inventory (which can be modelled on the detailed California database) should include:

   a. the type, age, capacity, location, owner and service contractor for each on-site generator with a nameplate capacity exceeding 300kW;

   b. a quantitative and qualitative rating of the generator for its efficiency and environmental performance. The aim would be to identify cleaner systems that

may be more appropriate for more extended use and ones with higher emissions and/or lower efficiencies that are suitable for emergency back-up purposes only; and

c. an assessment of the average and peak electricity demand for the sites being supplied and a determination of the likely capacity available for network demand reduction.

Subsequent to the preparation of a comprehensive inventory, an implementation strategy is to be prepared demonstrating how each standby generator could best be called upon at times of stress on the supply network to:

(a) take load off the system by meeting the load requirements of the sites they serve; and,

(b) if practicable, reduce network demand further by supplying any surplus electricity into the network.

7. The implementation strategy is to recommend technical, commercial and operational approaches to maximising the opportunities to rely on this distributed energy source, and provide a model business case for the owners of standby generators that demonstrates how they could be compensated to make their involvement commercially viable. Following implementation, the model is to be documented and made available for use in other constrained regions in NSW seeking to implement distributed generation.

8. The strategy is to evaluate the major facilities in the region that offer opportunities for power factor correction. Each site evaluation should include:

   (a) Measurement of the current power factor;

   (b) Assessment of opportunities for power factor correction; and

   (c) Preparation of a summary business case for each site where opportunities exist.

   The evaluation approach and summary information is to be documented and made available for use in other constrained regions in NSW seeking to implement a power factor correction initiative.

9. The strategy should evaluate the major facilities for interruptible load opportunities. Each site evaluation should include:

   (a) identification of any loads that could potentially be interrupted without causing major disruption or inconvenience;

(b) a technical and commercial assessment of the feasibility of interrupting identified loads; and

(c) preparation of a summary business case for each site where opportunities exist.

A summary of the database that results from this project is to be documented and made available for use in other constrained regions in NSW seeking to implement load interruptibility initiatives.

10. The strategy should evaluate the major facilities for their energy demand reduction opportunities, including improvements in equipment efficiency, cogeneration and energy management controls. Each site evaluation should include:

    (a) an energy audit, including evaluation of energy usage characteristics and characterisation of thermal loads;

    (b) technical and commercial assessment of the feasibility of any energy demand reduction opportunities identified;

    (c) preparation of an energy demand reduction programme; and

    (d) preparation of a summary business case for each site where opportunities exist.

11. Where relevant to the objectives of providing practical and accurate information on the opportunities for demand reduction, the strategy should support the implementation and promotion of demonstration projects. The range of projects considered should encompass a wide range of target sites and include documentation of the technical and commercial aspects to assist in the dissemination of information to building owners, developers, design professionals, energy service providers, other network service providers and the general public.