

Lynley Jorgensen
Director
Australian Energy Regulator
GPO Box 520,
Melbourne 3001
Victoria

SYDNEY
180 Thomas Street
Sydney NSW 2000
PO Box A1000 Sydney South
NSW 1235 Australia
T (02) 9284 3000
F (02) 9284 3456
www.transgrid.com.au
DX1122 Sydney

Dear Ms Jorgensen

TransGrid's Response to CCP Submission – September 2014

TransGrid appreciates the opportunity provided by the AER to respond to the submission made by the Consumer Challenge Panel (CCP) on TransGrid's revenue proposal.

The AER has established the CCP to assist it to make better regulatory determinations by advising it on issues that are important to consumers. TransGrid welcomes the involvement of the CCP in the revenue determination process and recognises the important role it plays.

TransGrid's experience has been that in the early operation of the CCP, several changes to the membership of the CCP6 sub-panel have affected the continuity of engagement between the sub-panel and TransGrid. As a result, the CCP has had very few meetings with TransGrid prior to its submission on the proposal. TransGrid expects that in future submissions from the CCP, the information provided will be on the basis of more comprehensive engagement and that TransGrid will have the opportunity to provide more complete understanding of key elements of its proposal.

With regard to the current CCP submission, TransGrid considers that there are a number of comments that require further consideration.

Price Reduction Drivers

Change in Financial Market Conditions

The CCP notes significantly lower cost of capital requirements at the time of this revenue proposal than at the time of the last proposal (p3).

TransGrid agrees with the CCP that financial market conditions are currently very different than those that applied at the time of the last revenue reset. The revenue proposal recognises this and proposes a lower WACC, reflective of current financial market conditions. TransGrid's proposal also supports a complete change in the methodology to avoid the volatility in cost of debt setting experienced in the last period. To that end, TransGrid supports the AER's decision to move away from the on-the day method for determining cost of debt to historic trailing average and has proposed an immediate adoption of this methodology.

Downturn in Electricity Consumption and Demand

The CCP observes a downturn in electricity consumption and demand over the previous regulatory control period, and asserts that demand is forecast to drop further in the next regulatory period. The CCP also suggests that this significantly reduces the requirement for capital and operating expenditure (p3).

Whilst there has been a significant decrease in electricity consumption across the National Electricity Market during the last regulatory period, the same cannot be said for peak demand in NSW. TransGrid, as with all TNSPs, plans its network primarily to meet peak demand, as required by jurisdictional planning standards.

The highest recorded summer peak demand in NSW occurred in 2010/11, with 2008/09, 2009/10 and 2012/13 recording very consistent, high peaks. In contrast, 2011/12 and 2013/14 recorded comparatively low summer peaks. On a temperature corrected basis, this trend is somewhat smoother and shows a decrease of about 4% in summer peak demand over the last four years, a large proportion of which was due to the closure of Kurri aluminium smelter. This is not a significant drop in peak demand.

The CCP also asserts that demand is forecast to drop further in the next regulatory period. However, in the *2014 National Electricity Forecasting Report*, AEMO in fact forecasts modest annual peak demand growth in NSW. The forecast level of state demand growth is not driving network augmentation, and this is reflected in TransGrid's capital expenditure forecasts. However, during TransGrid's consumer consultation, representatives raised concerns that demand forecasts may be optimistic. In response, TransGrid considered the effect of a scenario of falling peak demand on its forecast capital expenditure, including replacement expenditure. The outcomes of this assessment are set out in Section 5.7.6 of the revenue proposal, and TransGrid is satisfied that its proposed capital portfolio is the most appropriate across a range of scenarios, including a scenario of falling peak demand.

Further, in the small number of cases where changes in demand have reduced the required capacity on particular flow paths, TransGrid has responded by deciding to decommission assets that would otherwise need to be replaced. These decisions have been clearly set out in the revenue proposal (pp50, 106).

Response to Regulatory Incentive Schemes

The CCP recognises TransGrid's strong historical service performance (pp3, 9), and infers that this strong performance should result in a reduction in replacement capital expenditure in future.

The regulatory framework for the National Electricity Market is at the leading edge of regulatory economics and is based on an incentive based framework. TransGrid is expected to respond to the incentives built into the regulatory framework, and indeed the framework would be broken should any business not do so. On this basis TransGrid is justifiably pleased with its performance against the regulatory incentive schemes and its ability to rise to the regulatory challenges set.

However, the CCP's linkage of incentive scheme performance in the past regulatory period to replacement capital expenditure in the new regulatory period is somewhat tenuous. The service performance scheme applicable to TransGrid in the 2009-14 regulatory control period was designed to primarily create incentives relating to day to day operational decisions, rather than capital investment

decisions.¹ Whilst the prudent timing and co-ordination of planned maintenance activities and responses to unplanned outages contribute to strong performance under the incentive schemes, they does not have significant bearing on replacement capital expenditure.

Further, even if a linkage did exist as suggested by the CCP, throughout the last regulatory control period TransGrid has consistently not received bonuses against the component of the scheme that relates to reliability. This would actually imply the opposite conclusion to that drawn by the CCP.

Consumer Engagement

The CCP has expressed a view that TransGrid's consumer engagement activity to date has been at the "Inform" level of participation (p3). However, the CCP has not participated in any of the extensive consumer consultation that TransGrid has undertaken on the revenue proposal, and TransGrid questions the basis on which the CCP has arrived at many of its conclusions.

TransGrid has made a genuine and significant effort to engage with various stakeholders during the development of the revenue proposal. In order to ensure a comprehensive cross section of consumer views, surveys, focus groups, roundtables and deliberative forums were targeted at general consumers, with workshops and briefings held with key consumer representatives and large energy users.

The program was designed to cross various aspects of the IAP2² spectrum, with careful consideration given to identifying issues on which consumers could be "Consulted" and "Involved" and given a genuine choice/input (i.e. operating expenditure step changes and capital expenditure profile), and when it was more appropriate to "Inform" them of TransGrid's plans (i.e. rate of return). Participants at the workshops were given the opportunity to challenge TransGrid on its stance, and robust discussions were held on a number of topics, as evidenced in the follow up report by the independent facilitator.³ Further, TransGrid discussed its responses to the feedback provided by participants in earlier workshops and briefings with those participants at subsequent workshops and briefings.

Statements by the CCP such as "push-poll driven" (p4) do not align with the feedback TransGrid has received. In the questions it asked of consumers, TransGrid was careful to separate "willingness to pay" questions from questions relating to the forecasts in its revenue proposal, as evident in the Qualitative Research Report⁴ and Quantitative Survey Results⁵ and cited in the revenue proposal. Participants were provided with clear information on the cost and price impact of forecast expenditure, including specific items of proposed expenditure such as the demand management initiative allowance and the extent of consumer engagement.

With residential and small business consumers, the direct impact on end consumer bills was provided to assist consumers to assess their preferred option. With large energy users, the impact was discussed at an overall level, as the differences in energy usage patterns between users preclude a "one size fits all" calculation of impact on bills.

¹ AER, *Explanatory Statement: Electricity Transmission Network Service Providers Draft Service Target Performance Incentive Scheme*, September 2012, p36.

² International Association of Public Participation Spectrum:
<https://www.iap2.org.au/sitebuilder/resources/knowledge/asset/files/36/iap2spectrum.pdf>

³ TransGrid Summary of Consultation on Five Year Plan, Final Version 15 May 2014: <http://yoursaytransgrid.com.au/summary-of-consultation-on-transgrids-revenue-proposal>

⁴ Qualitative Research Report – Final Version: <http://yoursaytransgrid.com.au/november-deliberative-forums>

⁵ April 2014 TransGrid Quantitative Survey Results: <http://yoursaytransgrid.com.au/five-year-plan-and-revenue-proposal-online-survey>

TransGrid has ensured that a highly transparent consultation process has been undertaken, with all consultation material on TransGrid's website <http://yoursaytransgrid.com.au/>. TransGrid engaged the support of leading external consultants to plan the consultation approach, prepare independent reports on the consultation that occurred and identify key issues to be addressed in the revenue proposal. TransGrid received feedback on every consultation session to ensure the process could evolve as effectively as possible.

A multi-stage process was adopted to ensure there was an opportunity to test whether what had been heard at the forums was accurate and the response in the revenue proposal was appropriate in both form and scale. All of this approach is clearly set out in the revenue proposal (pp35-47). All material from the consultation sessions and independent reports are publicly available on the website.

Whilst the topic is discussed more fully in the revenue proposal (pp35-47), a summary of how TransGrid incorporated the feedback obtained from consumers in its revenue proposal and pricing methodology is as follows.

Consumer Feedback	How TransGrid Addressed in Proposal
The balance of price and reliability was generally thought to be satisfactory. 49% of consumers were willing to pay more than \$3 extra per annum to improve reliability; 31% were willing to pay \$3 extra (ie, around CPI) per annum to maintain reliability, 12% were willing to pay some increase but less than \$3 per annum and will accept a decrease in reliability; 8% were not willing to pay any increase and will accept a decrease in reliability.	80% of consumers were willing to pay an increase in line with CPI or larger in order to maintain reliability standards. TransGrid has proposed a capital programme and revenue increase in line with CPI which is targeted at maintaining existing levels of reliability.
TransGrid should consult more broadly on projects from early stage of establishing the need, and more proactively pursue alternative solutions such as demand management.	For the supply to Sydney CBD and inner metropolitan area, TransGrid proposed a demand response solution, with a capital project as contingent in the event that insufficient demand response is available. This will defer or avoid the \$430 million capital project if sufficient demand response is available to meet the need.
Transmission pricing should be more cost reflective, have charges allocated based on peak demand and provide greater certainty.	TransGrid made six changes to its pricing methodology to make it more cost reflective, have charges allocated based on peak demand and provide greater certainty.
TransGrid should more proactively pursue demand management.	TransGrid has proposed an increase in its demand management innovation allowance for targeted demand management innovation. In a survey of residential and small business consumers, the majority supported this initiative.
Consumer engagement that is proactive, transparent and underpinned by a genuine desire to inform, consult and collaborate effectively.	TransGrid has proposed expenditure specifically on consumer engagement. In a survey of residential and small business consumers, the majority supported the details of this initiative.

Consumer Feedback	How TransGrid Addressed in Proposal
Demand forecasts published by AEMO may be too high.	In its revenue proposal, TransGrid assessed its capital portfolio against a scenario of falling peak demand. TransGrid is satisfied that its capital portfolio is the most appropriate across a wide range of scenarios, including the scenario of falling peak demand.
TransGrid needs a plan to manage stranded assets in response to consumers going "off grid" or closure of generators.	TransGrid has set out in the revenue proposal how it would respond to stranded assets, should these eventuate.

Price Impacts

TransGrid is unable to calculate the price impacts the CCP have cited in their submission associated with TransGrid's revenue proposal (p4).

The price impacts of TransGrid's revenue proposal are clearly set out in the revenue proposal (p213).

From the maximum allowed revenue in 2013/14, TransGrid's proposed revenue allowance for 2014/15 results in a real 4% price decrease, or 1.5% nominal decrease. Prices then change at or below CPI thereafter, that is, at zero real price growth or 2.5% nominal.

From the revenue collected in 2013/14 following a revenue freeze, TransGrid's proposed revenue allowance for 2014/15 results in a real 3.5% price increase, or 6% nominal. Prices then change at or below CPI thereafter, that is, at zero real price growth or 2.5% nominal.

The CCP is correct that on a nominal basis, revenue for the 2014/15 – 2018/19 period is 25% higher than the 2009/10 – 2013/14 period. However, normal practice is to compare dollars over different years on a common dollar basis to understand the real change. For this reason, figures in the revenue proposal which are provided to facilitate comparisons over time are expressed on a real 2013/14 dollar basis. On this basis, the revenue change between the last regulatory control period and the current regulatory control period is a real 9% increase. The drivers for this increase in revenue are summarised in the consumer-friendly revenue proposal overview paper, and discussed in detail in TransGrid's revenue proposal.

Revenue Freeze

The CCP has expressed surprise at TransGrid's intention to recover revenue associated with a revenue freeze in 2013/14 (p4).

The revenue freeze was applied to the 2013/14 year to reduce price volatility for consumers who were facing a roller coaster of price increases, then decreases, followed by further increases arising from the timing of regulatory decisions and changing financial market conditions. This price volatility was understood to be undesirable for consumers, and following careful consideration TransGrid decided to implement the price freeze in 2013/14 to reduce price volatility over a number of years by stabilising prices and revenue collection.

Whilst TransGrid intends to recover this revenue, and this was made clear to TransGrid's customers when the revenue freeze was implemented, any recovery will be dependent on the specific circumstances in any given year and TransGrid remains mindful of its commitment to limit revenue

growth to CPI over the coming regulatory control period. For this reason there is no detail on when and if TransGrid will recover this revenue as, at this time, it is unknown whether this will indeed occur.

The 2013/14 revenue freeze is not part of the revenue decision for the 2014/15 to 2018/19 period, and as a consequence does not feature prominently in the revenue proposal. Nevertheless, there are a number of references to it within the proposal for transparency, and TransGrid discussed it openly at its presentation at the AER's public forum on the revenue proposal in July 2014.

Return on Capital

TransGrid's Submission

The CCP asserts that TransGrid's submission on the cost of capital has not been submitted to any rigorous analysis or stakeholder consultation (p5).

TransGrid disagrees with the CCP's assertion. TransGrid's submission on the cost of capital includes:

1. a 20-page plain English chapter within the revenue proposal;
2. a detailed overarching paper written by NERA, one of the world's leading economic consulting firms which specialises in regulated industries and estimating the cost of capital, and has held leadership roles in designing the electricity industry regulatory frameworks worldwide, including in Australia;
3. three supporting papers providing rigorous analysis of technical aspects of the cost of capital estimation from leading Australian academic and financial and economics consultants, namely SFG Consulting and Incenta Economic Consulting; and
4. two papers from expert participants in the financial markets, namely Westpac and Grant Samuel.

TransGrid's submission was broadly consistent with the position taken by both the Energy Networks Association and TransGrid in their respective submissions to the AER on the Rate of Return Guideline (guideline) and in TransGrid's transitional revenue proposal. On that basis, TransGrid's approach has been actively discussed in public consultation for more than a year.

In addition, TransGrid discussed the approach to WACC taken in its revenue proposal during its own consumer engagement sessions, details of which are available on TransGrid's website.

The AER has found TransGrid's revenue proposal to be fully compliant with both the National Electricity Rules (Rules) and the AER's guideline. TransGrid has clearly identified which aspects of the return on capital calculation depart from the AER's guideline and why. TransGrid has agreed completely with the AER's methodology for estimating the cost of debt and has applied that methodology entirely. TransGrid has not agreed with the AER's assumption that there is a need for a transition to this methodology for all businesses. The imposition of a transition creates a material detriment to the business as it would result in a cost of debt well below the rate the AER has assessed as the efficient benchmark cost of debt.

TransGrid does not consider that the AER's approach to estimating the cost of equity in the Rate of Return Guideline is compliant with the Rules. TransGrid has proposed an approach which it considers

is compliant with the Rules, and has made this clear in the revenue proposal as required under the guideline. TransGrid has proposed a cost of equity on the basis of all the relevant material available.

Comparison with International Regulators

The CCP compares the rates of return set in recent Australian regulatory decisions to those set by international regulators (p7).

TransGrid considers that this comparison is not valid. TransGrid is an Australian business operating in Australia. In the same way that Australian residents' mortgage rates have been typically significantly higher than their counterparts in the USA or UK in recent years, so too is the cost of debt for Australian businesses. Whilst Australian banks will source debt overseas for both residential and business customers, there remains a persistent wedge between the cost of debt in Australia and the comparable rate in the USA or UK, primarily driven by the corresponding currency hedge required when raising debt overseas.

Capital Expenditure

Comparison of Proposed and Historical Capital Expenditure

The CCP attempts to compare TransGrid's proposed capital expenditure for the next regulatory control period with the historical capital expenditure in the previous regulatory control period (p8).

TransGrid considers that the comparison made by the CCP is not "apples for apples", as the CCP has arbitrarily removed the largest capital project from TransGrid's portfolio in the last period without any discussion or explanation of the rationale. TransGrid considers that the relevant comparison including all capital expenditure, in 2013/14 dollars as a common base, is as follows:

\$m (2013/14)	2009/10 – 2013/14	2014/15 – 2018/19	Change
Total Capital Expenditure	2,251.03	1,608.36	28% decrease

"Pre-installed" Replacement Capital Expenditure

The CCP claims that TransGrid has "pre-installed" a good deal of its replacement capital expenditure, in response to an observation of actual replacement expenditure above that forecast in TransGrid's last revenue determination (p9).

TransGrid's revenue proposal only relates to capital expenditure expected to occur between 2014/15 and 2018/19, and expenditure in a previous regulatory control period is naturally not part of the revenue proposal for the upcoming regulatory period. TransGrid confirms that there has been no double counting of capital expenditure across regulatory control periods. TransGrid plans and prioritises asset replacement based on condition and specific needs, and the schedule for some projects due to be commissioned early in the upcoming regulatory period requires the early stages of project planning to commence sufficiently in advance for needs dates to be met.

Drivers for Asset Replacement

The CCP asserts that TransGrid's revenue proposal does not provide justification for an increase in replacement expenditure, other than comments related to the age of the asset base (p9).

This is incorrect. TransGrid's revenue proposal clearly states that, "replacement projects are driven by condition risks of assets that are reaching the end of their serviceable lives. TransGrid has adopted an economic methodology to assess the condition risks of its assets and determine the need for replacement or refurbishment. Assets are not automatically replaced on a like-for-like basis, but are optimally reconfigured for future load requirements and as identified through efficient asset management decisions" (p69).

In fact, almost 20% of TransGrid's assets have fully depreciated and are therefore no longer in the regulatory asset base. TransGrid will continue to maintain these assets in service until their condition indicates a level of risk that raises a need for replacement.

As the CCP is aware, both the AER and CCP have been provided with approximately 25,000 pages of engineering based condition assessments, risk assessments and detailed option analysis and costings for all replacement projects. These robust justifications form part of the revenue proposal submission, exactly as the CCP is calling for. The CCP has had access to this documentation since mid July 2014, and has not raised any concerns in its submission.

As part of its consumer engagement process TransGrid asked consumers, consumer representative groups and large energy users how TransGrid could best present this depth of technical information to ensure it was transparent, accessible and credibly assessed. Responses ranged from relying on the AER to undertake the detailed review, to engaging an independent engineering firm to critique the capital program, to making all documentation publicly available.

TransGrid responded to these responses with a plain English discussion of the capital expenditure forecasts in Chapter 5 of the revenue proposal. TransGrid also engaged GHD, a well recognised firm of expert engineering consultants, to undertake an independent, detailed review of TransGrid's capital program prior to submission of the revenue proposal. GHD's report is included as Appendix K to the revenue proposal. Public versions of all documentation have been submitted to the AER, and naturally the AER is undertaking its own review assisted by its own expert advisers. This would appear to address all options considered by consumers and their representatives.

TransGrid notes a statement from the CCP that premature replacement of assets on the basis of age rather than condition is inappropriate (p9). TransGrid agrees with this statement, but observes that it does not relate to TransGrid's revenue proposal.

Operating Expenditure

The CCP attempts to compare TransGrid's proposed operating expenditure for the next regulatory control period with the historical operating expenditure in the previous regulatory control period (p10).

TransGrid considers that the comparison made by the CCP is not "apples for apples", as it has not recognised a change in accounting treatment between regulatory control periods to accommodate the AER's expressed preference in its Expenditure Forecast Assessment Guideline. The relevant comparison for operating expenditure, in 2013/14 dollars as a common base excluding debt raising costs and network support, is as follows:

\$m (2013/14)	2009/10 – 2013/14	2014/15 – 2018/19	Change
Total Operating Expenditure	812.2	898.7	11% increase

Labour Escalation

The CCP states that TransGrid is currently negotiating a new Enterprise Bargaining Agreement (EBA) (p11).

This statement is incorrect. The EBA was settled in June 2014 and is accurately reflected in TransGrid's operating expenditure forecasts for the life of the agreement. For the later years, following the expiry of that agreement, TransGrid has relied on expert labour market forecasters to estimate the appropriate labour costs. BIS Shrapnel's analysis of the labour market and its drivers is included as Appendix H to the revenue proposal.

Step Changes

The CCP raises the question of whether step changes should be accommodated within productivity improvements (p11).

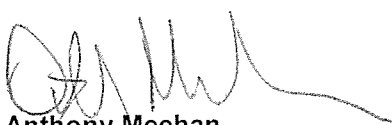
The regulatory framework is designed on the basis of building blocks and efficient base year costs. The CCP has already noted that TransGrid responds well to the incentive framework presented. The incentive framework is designed to elicit an efficient base year. TransGrid has demonstrated the achievement of a wide range of efficiencies in its proposal and, with the exception of the specific items discussed in the revenue proposal, considers the base year to be efficient. The step changes proposed are legitimate additional costs faced by TransGrid.

Evidence Based Analysis

To ensure that the CCP is able to fulfil its charter well, TransGrid requests the AER to require evidence based analysis from CCP members to support their positions. TransGrid has raised concerns in this response with what it considers to be unsubstantiated claims by the CCP or selective presentation of information that could lead readers to incorrect conclusions about TransGrid's revenue proposal. TransGrid requests the AER to review these aspects of the CCP submission.

Should you wish to discuss any aspect of this response further, please contact Nicola Tully, Manager/Revenue Reset, on (02) 9284-3120.

Yours sincerely



Anthony Meehan

Executive General Manager/Revenue Strategy and Business Diversification

8/9/12