

Mr Mike Buckley
General Manager Network Regulation North
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Email: aerinquiry@aer.gov.au

201 Elizabeth Street (cnr Park St)
PO Box A1000 Sydney South
New South Wales 1235 Australia
Facsimile (02) 9284 3456
Telephone (02) 9284 3000
Web <http://www.transgrid.com.au>
DX 1122 Sydney

Dear Mike

TransGrid's response to the submission by the Energy Markets Reform Forum

TransGrid appreciates the opportunity to respond to the submission by the Energy Markets Reform Forum (EMRF) dated August 2008 on the TransGrid Revenue Proposal 2009/10 – 2013/14, and the EMRF presentation made at the Australian Energy Regulator (AER) Pre-determination Conference on 9 December 2008.

This response includes references to the following documents:

- AER Draft Decision, TransGrid transmission determination 2009-10 to 2013-14
- Minutes of the Pre-determination Conference for TransGrid and NSW transmission and distribution determinations, 9 December 2008
- TransGrid's Revenue Proposal dated 31 May 2008
- TransGrid's revised Revenue Proposal dated 14 January 2009

TransGrid would like to address the following matters raised by the EMRF:

1. Changes in the economic and business environment
2. Ability to gain funding and spend capital allowance
3. Growth in demand
4. Capital expenditure and the impact on operating expenditure
5. Impact on prices
6. Regulatory framework

1. Changes in the economic and business environment

The EMRF has raised concerns stemming from the change in the economic and business environment due to the global financial crisis not being recognised in the Draft Determinations. In its revised Revenue Proposal, TransGrid has also raised concerns that the averaging period used to determine the risk free rate and debt risk premium should be reviewed to ensure that the recent global financial crisis does not unduly affect long-term average returns to investors.¹

The EMRF has stated that material costs are likely to be lower than in the current period. Whilst the forecasts² may indicate a decrease in commodity prices within the base currency of US dollars (USD), these costs need to be adjusted to account for depreciation in the Australian dollar relative to USD. Competition Economists Group (CEG) in its report on cost escalators, submitted as Appendix E of TransGrid's revised Revenue Proposal, has noted a non-forecast 25% depreciation in the Australian dollar

¹ TransGrid's revised Revenue Proposal 1 July 2009 – 30 June 2014, pages 51-62.

² EMRF, Review of AER DD on NSW electricity network businesses, Presentation by David Headberry and Bob Lim, December 2008, pages 9-12

between the original submission in April 2008 and the revised submission in January 2009.³ There have been further declines in the exchange rate since this time.

Therefore in such an economic environment, TransGrid believes that its proposed forecast of required capex and opex reasonably reflects the efficient costs of a prudent operator in achieving the expenditure objectives of the NER. Further, the methodology adopted by TransGrid provides a realistic expectation of the future cost inputs required to achieve the capex and opex expenditure objectives.

The EMRF has also stated that the AER's application of cost escalators is driving a step change in capex and opex for transmission network service providers (TNSPs), when the opening regulatory asset base (RAB) already accounts for these premiums. The application of the cost escalators provides for an adjustment of current prices to reflect expected movements in future cost inputs, and it is incorrect to assert that these future cost movements should not be applied to a base simply because it includes past cost movements.

The AER has stated that the cost escalation factors will be updated closer to the time of the Final Determination and TransGrid is of the view that this will ensure that these factors reflect the most up-to-date view of future input cost paths.⁴

2. Ability to gain funding and spend capital allowance

The EMRF has raised a concern that NSPs may be unable to secure debt funding due to the changes in economic conditions driven by the global financial crisis. TransGrid notes the AER's position⁵ that NSPs with stable cash flows and locked in rates of return will be likely to be able to raise the capital to fund capital investment programmes, but TransGrid believes that the rates of return must be set at a level that is seen as attractive by investors.

TransGrid does not foresee problems in raising funds for its capital works programme. The issue is at what cost that funding can be obtained. It is for this reason that the AER's decision with regard to TransGrid's rate of return for the regulatory control period commencing July 2009, and the outcomes of the current AER review of the weighted average cost of capital (WACC) parameters on future regulatory control periods is of paramount importance in ensuring TransGrid is sufficiently compensated, as contemplated by provisions in the National Electricity Law (NEL) and National Electricity Rules (NER).

The EMRF has stated that there is a risk that the AER determined capex allowance may not be spent during the regulatory period due to an inability to obtain funding resulting in "free revenue". TransGrid reiterates the AER's position that debt funding is likely to be available to TNSPs. TransGrid has demonstrated its ability to deliver the capex programme submitted in its Revenue Proposal which, following a thorough review by its consultant, the AER has accepted. TransGrid's ex ante expenditure needs have been expressly linked to meeting regulatory obligations. There is a strong incentive for TransGrid to deliver on its programs as any failure to deliver has material compliance and liability exposure implications.

The EMRF has also stated that capex funding can be spent on anything with impunity. Under the NER, the AER does not approve projects, rather they approve a capex allowance based on a reasonable expectation of requirements. This provision is necessary to allow network businesses to be able to respond to new project needs as they arise and to incentivise capex delivery efficiencies. There is also a requirement to expose proposed expenditure to extensive public scrutiny with scope for decisions to be disputed. Examples include the requirements to include proposals in the Annual Planning Reports and to conduct regulatory test⁶ consultations.

³ TransGrid's revised Revenue Proposal 1 July 2009 – 30 June 2014, Appendix E

⁴ AER, Draft Decision, TransGrid transmission determination 2009-10 to 2014-14, page 69

⁵ Minutes of the Pre-determination Conference for TransGrid and NSW transmission and distribution determinations,

9 December 2008, page 9

⁶ National Electricity Rules, Clause 5.6.5A. Further, Clause 5.6.6(b) requires TNSPs to consult on applications for new large transmission assets.

TransGrid believes that the NER reasonably accounts for any underspending during the regulatory period by using actual expenditure to calculate the opening RAB. If the capex spend is lower, then customers benefit in perpetuity from the lower rolled forward asset base. Thus, the incentive framework is designed such that whilst it may provide a short-term benefit to the TNSP, it then provides a long-term and enduring benefit to customers.

3. Growth in demand

The updated load forecasts used in support of TransGrid's Revenue Proposal were based on the NSW Annual Planning Report (APR) 2008 and were inclusive of carbon impact modelling.

The AER engaged McLennan Magasanik Associates (MMA) to conduct a review of TransGrid's demand forecasting methodologies and processes. Based on MMA's advice, the AER accepted TransGrid's demand forecasts as providing a realistic expectation of demand that anticipated the effects of the global financial crisis. The NSW distribution network service providers (DNSPs) have submitted updated load forecasts as part of their revised Revenue Proposals submitted in January 2009, which take into account current economic data and the impact of the Federal Government's Carbon Pollution Reduction Scheme. TransGrid is currently reviewing its capex programme in light of the updated DNSP demand forecasts. Initial indications are that no further reduction beyond that implemented by TransGrid in its updated capex proposal is possible. Confirmation of this is expected to be provided to the AER in late February.

The EMRF has stated that population growth rates in NSW have declined over the last 20 years and that this reduced growth rate is not reflected in TransGrid's capex allowance submissions. In its Revenue Proposal dated 31 May 2008, TransGrid indicated that load growth is driven by several factors including increases in population, increases in the number of households and increases in energy use per capita⁷. TransGrid also stated that over the last 20 years NSW had surplus generation and transmission capability, however economic and population growth has progressively reduced this surplus capacity. The Owen Inquiry into Electricity Supply in NSW in 2007 highlighted the need for additional base load generation potentially as early as 2013/14. The development of TransGrid's network is essential to provide the capability to support future generation.

Investment in transmission assets is "lumpy", based on the need to address capacity constraints as they arise within the various parts of the transmission network. Consequently, there is no direct correlation between aggregate load growth and total capital expenditure in the short to medium term. Significant expenditure on the NSW network was undertaken between the 1960s and the 1980s.⁸ Since the late 1980s, TransGrid has not needed to undertake as many transmission augmentations or large scale refurbishment of sites. Instead, the existing system has been maintained and operated to ensure that all efficiencies from existing infrastructure can be fully utilised before enhancement to the power system was required. These efforts have helped to keep prices down for the benefit of customers.

Recent record demands in Victoria have highlighted the impacts that can be experienced by the community when significant electricity supply interruptions occur. It should be noted that TransGrid also experienced a record summer demand in early February 2009 which exceeded TransGrid's median demand forecast. TransGrid highlighted in its Revenue Proposal dated 31 May 2008 that as peak demands increase and high demand periods lengthen throughout the year, capital expenditure is required to avoid reduced reliability to customers⁹. This regulatory period marks the beginning of a period of increased capital expenditure for TransGrid to ensure that NSW's transmission infrastructure continues to meet customer expectations. TransGrid's proposed capital investments will satisfy load growth and peak demand forecasts and also maintain system security and reliability.

4. Capital expenditure and the impact on operating expenditure

The EMRF has suggested that although installation of replacement assets leads to an increase in the Regulated Asset Base (RAB), this is not a justification for an increase in opex and that with a large capex

⁷ TransGrid Revenue Proposal 1 July 2009 – 30 June 2014, page 26

⁸ TransGrid's Revenue Proposal 1 July 2009 – 30 June 2014, Figure 5.10: Commissioning of new network assets, page 34

⁹ TransGrid's Revenue Proposal 1 July 2009 – 30 June 2014, pages 28-29

programme TransGrid's opex should not have increased to proposed levels. TransGrid rejects this assertion as TransGrid's increased capex is largely driven by three large projects, with replacement capex only making up approximately 21% of overall capex expenditure.

TransGrid has ensured that the forecast operating expenditure has been appropriately adjusted to reflect the reduced maintenance costs that result from lower maintenance required for new assets. However, TransGrid's revised Revenue Proposal clearly demonstrates that new assets do not come 'free' of opex obligations and this was supported by a review of opex maintenance by engineering consultants Sinclair Knight Merz (SKM)¹⁰. TransGrid's increased opex expenditure is driven by a number of factors including the growth of the asset base, the age profile of assets and rising labour costs.

The EMRF has questioned whether the ratio of operating expenditure to asset value (opex/RAB) is a reasonable measure of the efficiency of a TNSP. TransGrid agrees that this measure on its own does not provide a full picture of the efficiency of a TNSP, and a number of other measures can be used to assist in forming an opinion as to relative efficiencies. TransGrid provided several benchmarking studies as part of its Revenue Proposal, indicating that TransGrid was an efficient TNSP by both local and international standards. The AER in its annual regulatory reports on TNSP performance¹¹ provides a number of benchmark comparisons, including opex costs per line length and MW peak. All of these measures provide some indication of the level of efficiency of a TNSP, but care needs to be exercised when relying on one measure in isolation. TransGrid's performance against these measures, and in the various benchmarking studies, supports TransGrid's position as an efficient TNSP.

The EMRF has suggested that NSP claims are ambit and ambitious. TransGrid's proposal was developed to meet the availability and reliability needs of customers in NSW using sophisticated forecasting models. These models take into account load growth estimates, asset condition and probabilistic scenario modelling accounting for alternative generation options, market development and the impact of carbon policy to develop all capital and operating expenditure included in the proposal. Considerable supporting material was provided as part of the Revenue Proposal to support the expenditure forecasts. The AER, after extensive review by itself and its consultants Parsons Brinckerhoff Australia Pty Ltd (PB), has generally accepted these forecasts in its Draft Determination.

5. Impact on prices

The EMRF stated that price increases are excessive. TransGrid's Revenue Proposal addresses the needs of transmission users in NSW by providing a reliable transmission system and minimising constraints to the electricity market. TransGrid's capex and opex forecasts take into consideration the increasing energy needs of consumers and allow the network to be developed to facilitate connection of alternative forms of low carbon emission generation.

The emphasis of the NEL is not on price per se, but on meeting the National Electricity Objective which is "to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to-

- (a) price, quality, safety, reliability and security of supply of electricity; and
- (b) the reliability, safety and security of the national electricity system."

With this in mind, the Rules require the revenue caps to be determined on the basis of efficient costs required to meet defined objectives. They also require the AER to have regard for a wide range of factors beyond short term price impacts.

TransGrid's proposal has undergone extensive review by the AER and PB. TransGrid is confident that its proposal represents a reasonable and realistic estimate of the efficient costs to develop and maintain the transmission network in NSW to support continuing economic growth in the state.

TransGrid noted in its revised Revenue Proposal that the transmission cost represented approximately 6% of the delivered price for the average energy user. TransGrid believes a modest increase of

¹⁰ TransGrid's revised Revenue Proposal 1 July 2009 – 30 June 2014, Appendix L

¹¹ For example, see AER Transmission Network Service Providers Electricity Regulatory Report for 2006/07, August 2008, pages 49-50 and Regulatory Report for 2005/06, pages 65-68.

approximately \$4.90 per annum for a typical household¹² means that NSW and ACT end users will still benefit from the lowest cost transmission service in Australia.

6. Regulatory framework

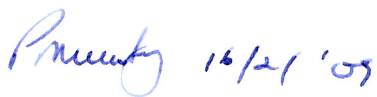
The EMRF has suggested that there is aggregated regulatory conservatism which is causing a massive overestimation of requirements. TransGrid supports the AER's position¹³ that any challenges to the assumptions and methodologies used to assess the expenditures proposed by the businesses must be supported by detailed analysis. The AER is obliged to implement the requirements of the NER and the NEL¹⁴, which requires the AER to provide regulated network service providers with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing network services and complying with a regulatory obligation.

In addition, the AER does not have discretion within the revenue decision making process over many of the issues raised by the EMRF, such as the WACC parameters prescribed in the NER, ex-ante approach to capex allowances and the variation of service standards to account for capex impacts. It is inappropriate for the EMRF to suggest that the AER is in error simply because the EMRF does not agree with the requirements of the NER.

TransGrid supports the consultation processes in place for any changes to the NER and would encourage the EMRF to raise their concerns via that process.

If you have any queries in relation to this submission, please contact Mr John Howland on (02) 9284 3509.

Yours sincerely



Peter McIntyre
General Manager/Network Development and Regulatory Affairs

¹² TransGrid's revised Revenue Proposal 1 July 2009 – 30 June 2014, page 100

¹³ Minutes of the Pre-determination Conference for TransGrid and NSW transmission and distribution determinations,

9 December 2008, page 3

¹⁴ National Electricity (South Australia) Act 1996, Clause 7A (2)