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Sebastian Roberts
General Manager – Networks Branch
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Locked Bag 14051
Melbourne City Mail Centre
Victoria 8001 Australia
T: 1300 360 795
www.ausnetservices.com.au

Dear Sebastian,

AusNet Services' Transmission – Revised Revenue Proposal

AusNet Services submitted its Revised Revenue Proposal for the 2017-22 regulatory period on 21 September 2016. This short follow-up submission is provided to:

- Inform the AER and stakeholders that the synchronous condenser at Templestowe Terminal Station has been retired. Expected savings in the remainder of the current regulatory period will be passed back to customers in the 2017-18 regulatory year through a reduction in forecast opex;
- Respond to the Consumer Challenge Panel's submission on the AER's Draft Decision; and
- Comment on relevant aspects of the Draft Decisions for TasNetworks and Powerlink that were published on 29 September 2016.

These items are discussed below.

Synchronous Condensers – Early Retirement

AusNet Services and AEMO have agreed that it is prudent to retire, rather than replace, the three remaining synchronous condensers (SCOs) on its network by 1 April 2017. SCOs play an important role in regulating the voltage of the network; however, the existing SCOs are in extremely poor condition and studies have confirmed that their replacement would not provide a net market benefit.

Since the retirement of the SCOs has been agreed, all three SCOs have failed due to poor condition. Given that the SCOs were due to be retired by 1 April 2017, AusNet Services and AEMO have agreed that it would not be efficient to return the SCOs into service.

In its Revised Revenue Proposal, AusNet Services has reduced forecast 2017-18 opex by \$84,000 to pass back to customers the avoided operating and maintenance costs to service the Brooklyn Terminal Station SCO in the 2016-17 regulatory year following its failure in May 2016.

In mid-September, the last remaining SCO (located at Templestowe Terminal Station) failed due to its poor condition. Consistent with the approach taken for the Brooklyn Terminal Station SCO, AusNet Services and AEMO have agreed to pass back to customers an additional \$76,000 in the 2017-18 regulatory year to account for the avoided cost of operating and maintaining the Templestowe Terminal Station SCO for the remainder of the 2016-17 regulatory year.

Therefore, AusNet Services' opex for 2017-18 should reflect a \$160,000 total adjustment for the early retirement of the SCOs. This deduction is in addition to the forecast operating and maintenance savings over the 2017-22 regulatory period of approximately \$0.3m per annum.

AusNet Services' proposed one-off opex increase to cover decommissioning the SCOs in the 2017-18 regulatory year is unchanged by these developments. To be clear, these decommissioning costs have been forecast as a one-off opex cost and not as an ongoing recurrent opex step change.

Response to the Consumer Challenge Panel's Submission

AusNet Services has considered the submissions to the AER's Draft Decision and takes this opportunity to respond to some issues raised by the Consumer Challenge Panel (CCP), including where it has requested additional information.

Decommissioning Opex for the Synchronous Condensers

The CCP's submission asks AusNet Services to 'provide details of past expensing of decommissioned assets that are not replaced, regardless of the size of the expenditure. This will assist in assessing whether there is a revealed cost and a justifiable step change..'¹.

AusNet Services can confirm that no asset decommissioning costs have previously been expensed. Historically, any asset that has been decommissioned (for example, because it has reached the end of its life), has always been replaced. Therefore, it has been standard practice for the cost of decommissioning to be capitalised, and added to the Regulatory Asset Base. The ongoing need for replacement has occurred due to the long period of demand growth which has been experienced.

The SCOs are the first Victorian transmission assets which have been retired and not replaced. As such, it is the first time that AEMO and AusNet Services have sought to amend the Network Agreement (established in 1994) to remove the services that existing assets provide. This is a prudent response to changing network characteristics.

Capital Expenditure – Safety Adjustment

AusNet Services has carefully considered the CCP's analysis of its safety risk cost approach and makes the following high-level observations:

- AusNet Services agrees that there is an important trade-off between additional safety expenditure, and a proportionality test should be (and, in fact, is) applied when assessing investment in improving safety outcomes.
- There is an important distinction between whether asset failure rates are known and whether asset failures are manageable and/ or controllable. While AusNet Services adopts a best practice approach to estimating asset failure rates, knowledge of the expected rate of asset failure does not mean the timing of asset failures can be controlled. For example, it may be known that an asset has a probability of failure within a year of 50%, however, the asset failure itself cannot be controlled or managed as it is not clear exactly when the asset will fail.
- Managing or controlling asset failure rates requires funding to maintain, refurbish or replace assets with unacceptably high failure rates. The substitute capex forecast in the Draft

¹ CCP Subpanel 5, Transmission for the Generations II, Response to AER Draft Decision for AusNet Services, page 16

Decision would severely constrain AusNet Services' ability to manage its asset failure rates to the degree it considers to be prudent.

- AusNet Services agrees that risk consequences are difficult to quantify and manage. For this reason, it has included a range of considerations and possible values of appropriate risk consequences in its Revised Proposal.

Both the AER's Draft Decision and the CCP's submission also express concern about the perceived assumptions made about the role of safety controls based on the following statement included in AusNet Services' Risk Management Policy & Framework:

"Potential Exposure will be estimated for each risk in terms of the total plausible worst case impact arising from a risk assuming all current controls fail."

The CCP is concerned that this statement implies that AusNet Services assumes that all its risk controls will fail and therefore safety risk is overstated². However, this sentence should be read within the context in which it has been provided. A fuller extract of this part of the Risk Management Policy & Framework is provided below:

"Risks will be rated and prioritised for attention using a consistent process of risk analysis. The process will involve estimating Control Effectiveness and using the AusNet Services' risk rating tables to arrive at the current level of risk."

Potential Exposure will be used as a measure to focus and plan control assurance activity. Potential Exposure will be estimated for each risk in terms of the total plausible worst case impact arising from a risk assuming all current controls fail."³

This explains that under its Risk Management Policy & Framework, AusNet Services does estimate the potential exposure for each risk by assuming the total plausible worst case impact assuming all current controls fail. This exercise is standard risk management practice, and is undertaken to establish the level of potential exposure for each risk, which is then used to plan control assurance activities.

AusNet Services has not suggested that estimating the 'worst case impact' is the approach that underpins our capex replacement practices. Instead, as outlined in our Revised Revenue Proposal, the controls listed in the Draft Decision are either taken into account in our safety risk quantification or irrelevant to the risk of explosive failure.

AusNet Services is happy to further discuss any other issues raised by the CCP. We would also like to thank the CCP (subpanel 5) for the constructive engagement and feedback that has been provided during the course of this review.

Powerlink and TasNetworks Draft Decisions

The Draft Decisions for Powerlink and TasNetworks, published on 29 September 2016, are the first decisions made by the AER incorporating the historically low (sub-2%) risk free rates seen in the market in mid- to late-2016. The approach taken in the Draft Decision raises two matters of concern for AusNet Services, being the appropriate cost of equity (specifically, the Market Risk Premium), and expected inflation.

Cost of Equity – Market Risk Premium

AusNet Services is concerned that the TasNetworks and Powerlink Draft Decisions do not address the prevailing market conditions. These Draft Decisions maintain a 6.50% Market Risk

² CCP Subpanel 5, *Transmission for the Generations II – Response to AER Draft Decision for AusNet Services*, pages 12 and 13

³ AusNet Services, *Risk Management Policy & Framework*, page 9

Premium, without considering whether the resulting overall cost of equity is appropriate in the current context of historically low risk free rates. The discussion contained in the Draft Decision for TasNetworks and Powerlink, which includes a risk free rate of 1.95%, is nearly identical to that included in the AusNet Services Draft Decision, which includes a risk free rate of 2.57%.

AusNet Services has raised concerns with the AER about the need to carefully consider whether the Market Risk Premium of 6.50% is appropriate in the current low risk free rate environment. Given the NER require the cost of equity to reflect the prevailing market return, AusNet Services' Revised Revenue Proposal includes evidence that focusses on the current market environment. We would be happy to discuss this matter further with the AER.

Expected Inflation

As outlined in AusNet Services' Revised Proposal, the current mismatch between the two inflation forecasts that feed into the PTRM – being the expectation implicit in the nominal WACC and the explicit expected inflation input – results in a material under-recovery of revenues. This mismatch results in networks not recovering their efficient costs.

The mismatch between the market's current expectation of inflation and the AER's expected inflation is apparent in the TasNetworks and Powerlink Draft Decisions. These embed a negative real risk free rate of approximately -0.5%, which is derived by converting the allowed nominal risk free rate (1.95%) into real terms using the AER's expectation of inflation (2.45%). However, today in Australia, investors can achieve positive real risk free returns through investing in index-linked Commonwealth Government Securities. This test should be applied as a sense check as to whether regulatory decisions reflect market realities.

AusNet Services is aware that the AER would like to undertake further consultation on expected inflation. AusNet Services welcomes further discussion of this topic and notes that our position on expected inflation was set out in our October 2015 Revenue Proposal and that stakeholders have had an opportunity to comment throughout our review process. The matter has also been raised in other review processes, including by the Victorian distributors in their April 2015 and January 2016 proposals, and SA Power Networks in its July 2015 Revised Proposal.

If the AER considers that further consultation on this specific matter is required, AusNet Services suggests that using the optional 'cross submission' part of this review process (which is designed to allow targeted consultation on specific issues) would be appropriate.

AusNet Services would be pleased to discuss matters raised in this submission with interested stakeholders. Please contact Charlotte Eddy, Principal Economist on 03 9695 6309 with any inquiries.

Sincerely,



Tom Hallam
General Manager Regulation and Network Strategy
AusNet Services