Submission by:

Energy Users Association of Australia

SUBMISSION TO THE ACCC - SUPPLEMENTARY DRAFT DECISION ON TRANSGRID & ENERGYAUSTRALIA'S REVISED TRANSMISSION CAPEX PROGRAMME

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FOREWORD

The Energy Users Association of Australia (EUAA) appreciates the opportunity to provide comments for consideration on ACCC's Supplementary Draft Decisions on TransGrid and EnergyAustralia.

As you may be aware, the EUAA is a non-profit organisation focused entirely on energy issues on behalf of large business end users of electricity and / or gas. The EUAA currently has approximately 75 members. Membership ranges across a number of sectors, including mining, manufacturing, construction, commercial property and service sector. Many of the EUAA's members operate across States.

Hence, this submission represents the views of large consumers of NSW transmission services. It also represents the views of large users more broadly across the NEM, noting that the New South Wales transmission system plays a critical strategic role in the NEM, influencing interconnection, inter-regional trade and energy prices. Our submission addresses the main issues of concern to our members and seeks to ensure that these issues are captured in the ACCC's final Determination.

The submission has been assisted by funding provided by the National Electricity Consumer Advocacy Panel and technical input from McLennan Magasanik Associates Pty Ltd (MMA). This support is gratefully acknowledged.

It should be noted, however, that the views expressed herein are solely those of the EUAA and its members.

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1 INTRODUCTION

The Energy Users Association of Australia (EUAA) appreciates the opportunity to provide comments for consideration in response to the ACCC's supplementary draft decision on TransGrid's and EnergyAustralia's transmission capital investment expenditure and revenue application. The EUAA is pleased that the ACCC has recognized that both EnergyAustralia and TransGrid have significantly over-estimated their capex requirements and has seen fit to reduce EnergyAustralia's capex by about $100 million and TransGrid's *ex-ante* allowance by about $200 million over the regulatory period. Nevertheless, we also recognize that the ACCC's proposed capex for EnergyAustralia still amounts to some $40 million (or 28.5%) above the actual capex spend in the previous regulatory period. In TransGrid's case, the *ex-ante* allowance amounts to over 20% ($158 million) above the actual spend over the previous period.

This submission addresses our main concern arising from the ACCC's supplementary draft decision and its shortcomings. As representatives of end use customers we expect the ACCC to fully address these concerns prior to finalising its decision. The concerns that we have may be summarised as follows:

- The ACCC failed to consider the sharing of any gains from capex underspend with customers partially compensating the transmission network service providers (TNSPs) for prudent overspending on projects that were not envisaged during the regulatory review;

- The ACCC failed to address the asymmetric manner in which the re-opening arrangements operate. While TransGrid is allowed to apply to re-open the revenue cap to pass through unforeseen cost increases to customers, customers have no right or mechanism to request any pass through of cost reductions.

- The ACCC has not imposed any requirements on TransGrid and EnergyAustralia to consider demand side solutions to reduce system peak load, instead of relying overwhelmingly on inefficient and costly network solutions to meet increased peak demand.

- The ACCC failed to ensure that the increased replacement capex sought and provided for by the ACCC is balanced by a corresponding reduction in operating costs.

We are also expressing our grave concerns with regard to the haste in publishing the supplementary draft decision and question if, in its haste, the ACCC has had the time to adequately, if at all, take into consideration any of our comments in the earlier submissions. Although the ACCC has reflected some of our comments in a number of areas in the supplementary draft decision, which we welcome, it does not effectively

address these comments or respond to many of our questions and suggestions. Table 1-1 shows the ACCC's response to the major issues raised in our earlier submissions.

Table 1-1 Issues Raised in EUAA's earlier submissions

EUAA's submission	ACCC's response
TransGrid	
Incentive for TNSPs to inflate capex	**No response**
Sharing of efficiency / gaming benefits	**No response**
Asymmetric treatment of re-opening mechanism	**No response**
Significant increase of capital expenditure when compared with its original application	Reduced the increase but still higher than original
Incentive for TNSPs to underspend in the initial years and back-end load capex	**No response**
75% increase in replacement capex with no corresponding reduction in opex	**No response.** Will only respond in final decision
Failure to comply with the *ex-ante* regime arrangements by including uncertain generation and interconnection related projects	Re-allocated from *ex-ante* allowance to excluded projects
Failure to consider demand side solutions	**No response**
Failure to include an assessment of the impact on consumers' bills	Provided impact on average TuoS only
EnergyAustralia	
Incentive for TNSPs to inflate capex	**No response**
Doubling of capital expenditure when compared with its original application	Reduced the increase but still higher than original
Substantial increase in replacement capex with no corresponding reduction in opex	**No response** Will only respond in final decision
Failure to adequately justify the reasons for the massive increase in capex	**No response**
Unquantified amount for customer connections when such an amount should be provided for in the *ex-ante* allowance,	Rejected EA's application
Failure to specify how demand side management has been encouraged to reduce system peak load	**No response**
Failure to include an assessment on the impact on customers such a massive increase in capex will have on customer bills	Provided impact on average TuoS only

We are very disappointed that, on this basis, the ACCC seems to have ignored or failed to respond to so many of the concerns of large end users. All the more because the concerns we raised are significant in terms of their impact on users and as end users pay all TuoS

charges in New South Wales and therefore their concerns should be recognized and taken more seriously by the ACCC. We urge the Commission to remedy this in its final determination.

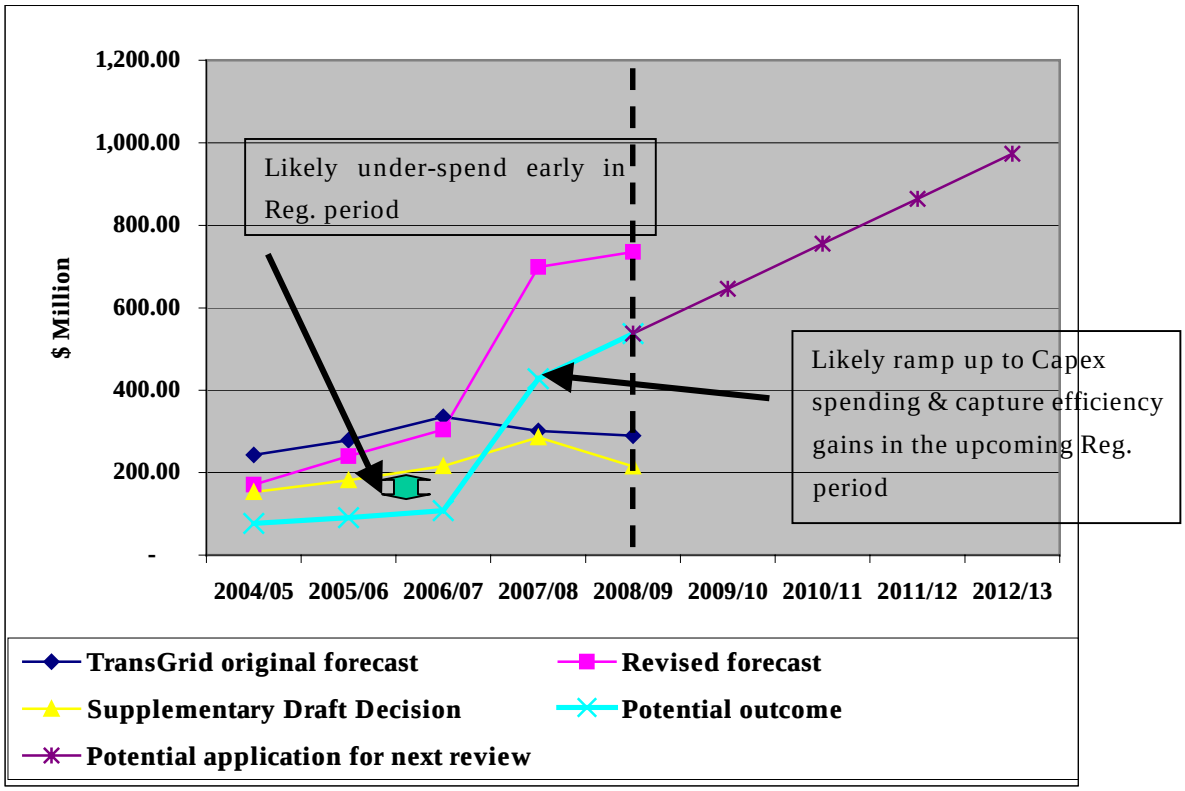
2 INCENTIVES OF THE *EX-ANTE* REGIME

Customers, although supportive in principle, are very concerned with the incentive structure of the *ex-ante* regime. We are concerned that the regime provides very weak incentives for the TNSPs to operate efficiently, while providing TNSPs with 'gaming' opportunities by manipulating the timing and size of their capex.

Of concern to customers in the new *ex-ante* regime is the potential incentives for the TNSPs to inflate the likely cost of capex given that the TNSPs will retain the returns of any underspend during the 5 year period. Overspending on the other hand, while not being compensated during the 5 year regulatory period, will simply be rolled into the asset base without any review at the next revenue reset. The impact of this arrangement is likely to see TNSPs underspend during the first three years of the regulatory period, which will result in substantial net revenue benefits. The TNSPs are then likely to overspend in the remaining years, when the penalty for overspending is limited, but would enjoy the benefits of a higher regulatory asset base for the life the assets, which are simply rolled into the asset base as there is no review mechanism in the *ex-ante* regime.

Figure 2.1 provides an indicative illustration on how we consider the ACCC *ex-ante* incentive regime will affect TNSP CAPEX spending behaviour.

Figure 2.1: Indicative TNSP spending behaviour



With the transition to this new arrangement, customers would urge the ACCC to keep a close eye on how the arrangements are actually put into practice by the TNSPs. The regime is new and untried and the ACCC will need to monitor and report on how the TNSPs respond to the arrangements and, if necessary, change the way the *ex-ante* arrangement operates. This comment is made on the basis of the significant increase in capex sought by both EnergyAustralia and TransGrid when compared with their historical capex, as well as when compared with their original application of 2004.

3 *EX-ANTE* ALLOWANCE AND EXCLUDED CAPEX

3.1 TRANSGRID

PB Associates has recommended reallocating a substantial portion of TransGrid's capex application from the *ex-ante* to the excluded category. This indicates that a significant number of projects identified by PB Associates have a high level of uncertainty and may not be undertaken during the next regulatory period.

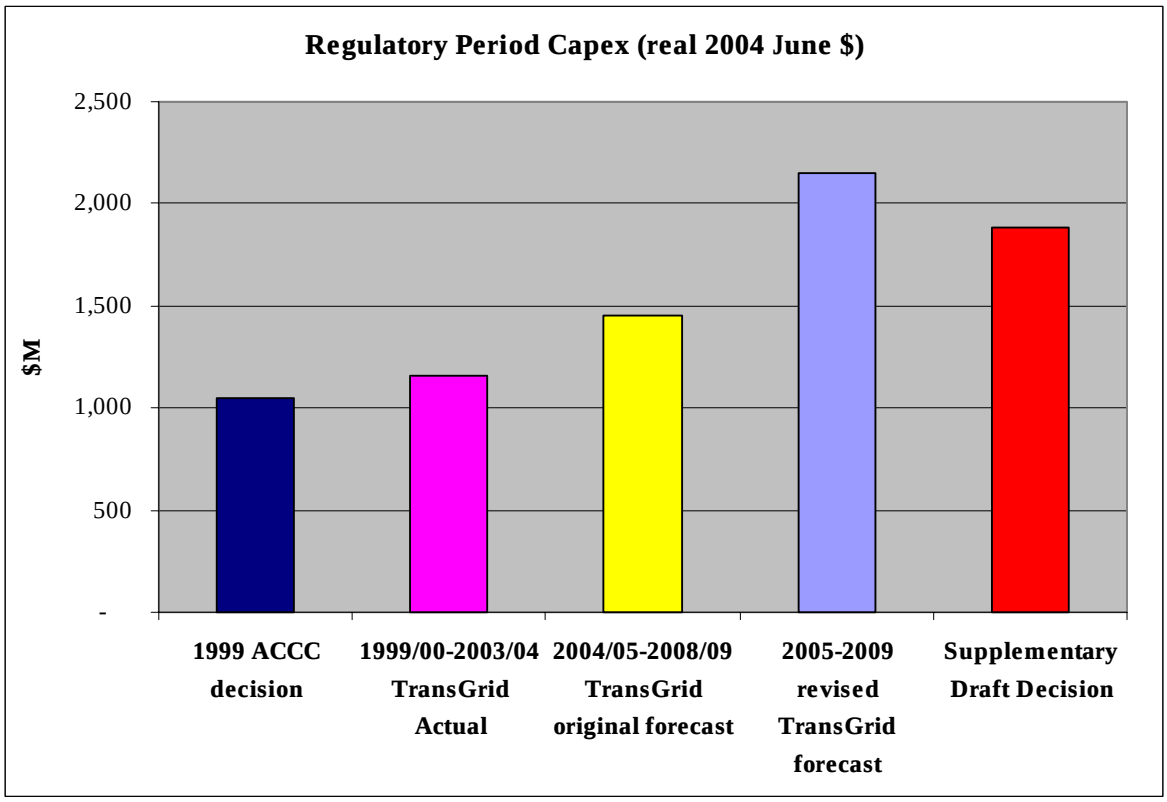
ACCC has significantly reallocated TransGrid's *ex-ante* allowance request to the excluded category. Nevertheless, in the supplementary draft decision, the *ex-ante* allowance (including indicative excluded capex of between $300-$400 million) still amounts to between 12% to 20% (or about $140 - $240 million, in real terms) above the actual spend over the previous period, 1999/2000 - 2003/04.

In our earlier submission, we questioned why TransGrid has increased its capex requirement from $1.45 billion (original application) to $2.15 billion (revised capex application). The ACCC has approved $1.05 billion of *ex-ante* allowance and another $930 million in excluded projects in accordance with the PB Associate's recommendations. This implies that about $430 million more capex may be required than envisaged during the time that TransGrid made its original application. This is shown in Figure 3-1.

Has demand increased to such an extent during the intervening period as to justify almost half a billion dollars of additional capex? Neither TransGrid nor the ACCC has provided any justification for this additional funding. Alternatively, can customers expect that reliability will be improved to the extent that the additional funding would imply? If so, TransGrid and the ACCC should specify how much reliability would improve and the penalties for failing to meet the improved standards sufficient to justify an additional $430 million investment.

In particular, page 16 of the ACCC's supplementary draft decision indicates that "TransGrid has forecast that approximately 1,600 MW of additional generation could be required within NSW during the next regulatory period". A review of NEMMCO's 2004 *Statement of Opportunities (SOO)* (and the January 2005 update) does not support TransGrid's forecast. No significant additional generation capacity has been forecast in NSW within the regulatory period. Although up to 300MW in Wagga Wagga, 200 MW in Buronga, 400 MW in Tallawarra and 800 MW in Tomago has been flagged in the SOO, none of these have reached the committed stage and their timing is uncertain.

Figure 3-1 TransGrid Regulatory Period Capex



If the increase in capex is not related to either increases in demand, or reliability improvements, the only other change is the *ex-ante* approval regime. This means that TransGrid is trying to lock in additional revenue through higher capex without fear that its expenditure would be stranded or optimized. With the draft *Statement of Regulatory Principles (SoRP)*, there may have been some risk when overspending the cap. However, the finalized SoRP has removed this risk by removing the cap and replacing it with an allowance. All overspending will be rolled into the asset base. The only penalty will then be the loss of return of and on capital during the regulatory period. By increasing the capex application, TransGrid seems to be seeking to minimize this possibility too.

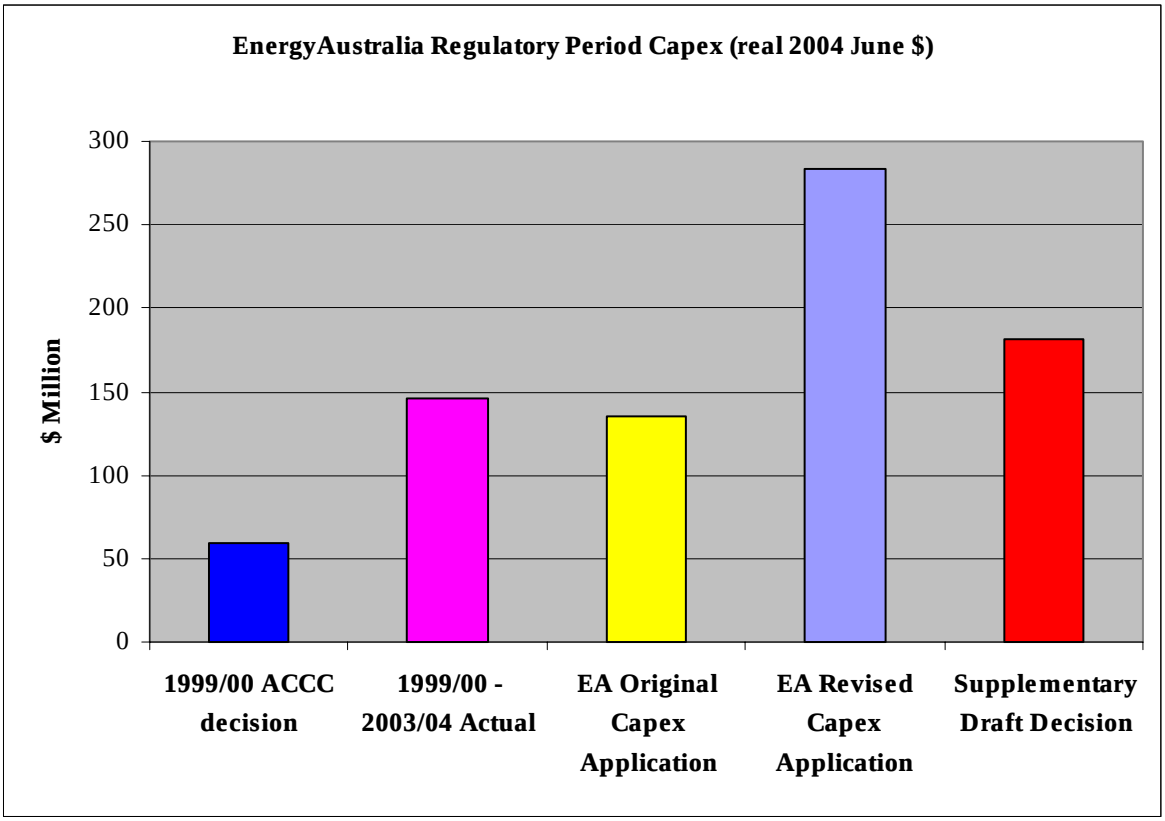
3.2 ENERGYAUSTRALIA

The ACCC's proposed *ex-ante* allowance for EnergyAustralia amounts to some $145 million plus another $37 million as indicative of excluded capex. While this represents a reduction of over $100 million from the capex requested by EnergyAustralia, it is some $35 million (or 24%) in real terms above the actual capex spend in the previous regulatory period, 1999/2000 - 2003/04. Customers are not convinced that this significant increase is justified.

The ACCC has approved a total of about $92 million in capex for EnergyAustralia (*Ex ante* allowance and excluded capex). This represents some $12 million more of capex than that envisaged when EnergyAustralia made its original application. This is shown in Figure

3-2. No justification for this increase has been provided by either EnergyAustralia or the ACCC in terms of increase in demand or reliability. What value can customer expect for this increase in capex?

Figure 3-2 EnergyAustralia Regulatory Period Capex



3.3 BENEFIT SHARING

Given the uncertainty of the excluded projects, we urge the ACCC to consider the sharing of benefits should these projects fail to proceed and the ACCC decide to include all (or part of) the excluded projects allowance in the Maximum Allowable Revenue. Since customers would have already begun paying for these projects in the current regulatory period, the savings achieved by not proceeding with these projects could easily be shared. The ACCC should consider allowing the sharing of any gains from capex underspend in the following regulatory period. To ensure symmetrical treatment, customers could partially compensate the TNSPs for prudent overspending on projects that were not envisaged during the regulatory review. This may reduce the incentive to the TNSPs to overstate expected capex spend, while still providing a level of incentive to operate efficiently. This could take the form of an imputed credit in the revenue over the next regulatory period, thereby reducing the TNSP's allowed revenue and consequently TUoS charges payable.

4 RE-OPENING OF REVENUE REQUIREMENTS

While the draft Statement of Regulatory Principles (SoRP) had indicated that TNSPs would not be compensated for any overspend above the *ex-ante* allowance, the final decision states that the written down value of the actual investment that complies with the code would be rolled into the Regulatory Asset Base (RAB). This change was made for the purpose of removing the asymmetric treatment of over and under spending on capex. However, to the detriment of customers, ACCC are not according the same treatment in re-opening the TNSPs' revenue requirements due to unforeseen events that lead to cost reductions. While customers are still expected to bear the pass through of any unforeseen cost increases, they have no right to seek adjustments for cost reductions.

This asymmetric treatment is highlighted in the recently published network tariffs in Victoria where the impact of the pass through of the transmission easement land tax has lead to customers facing increases of up to 24% for peak energy and 10% for maximum demand.

5 TRADE OFF BETWEEN REPLACEMENT CAPEX AND OPEX IGNORED

5.1 TRANSGRID

In its original application of September 2003, TransGrid states that "*as assets reach the end of their useful life the level of operating expenditure required to maintain them increases. TransGrid is continually optimising the replacement of these assets when the cost of doing so is less than the cost of maintaining them*". Similarly, EnergyAustralia stated in its original application that there will be a trade off between replacement capital and operating expenses.

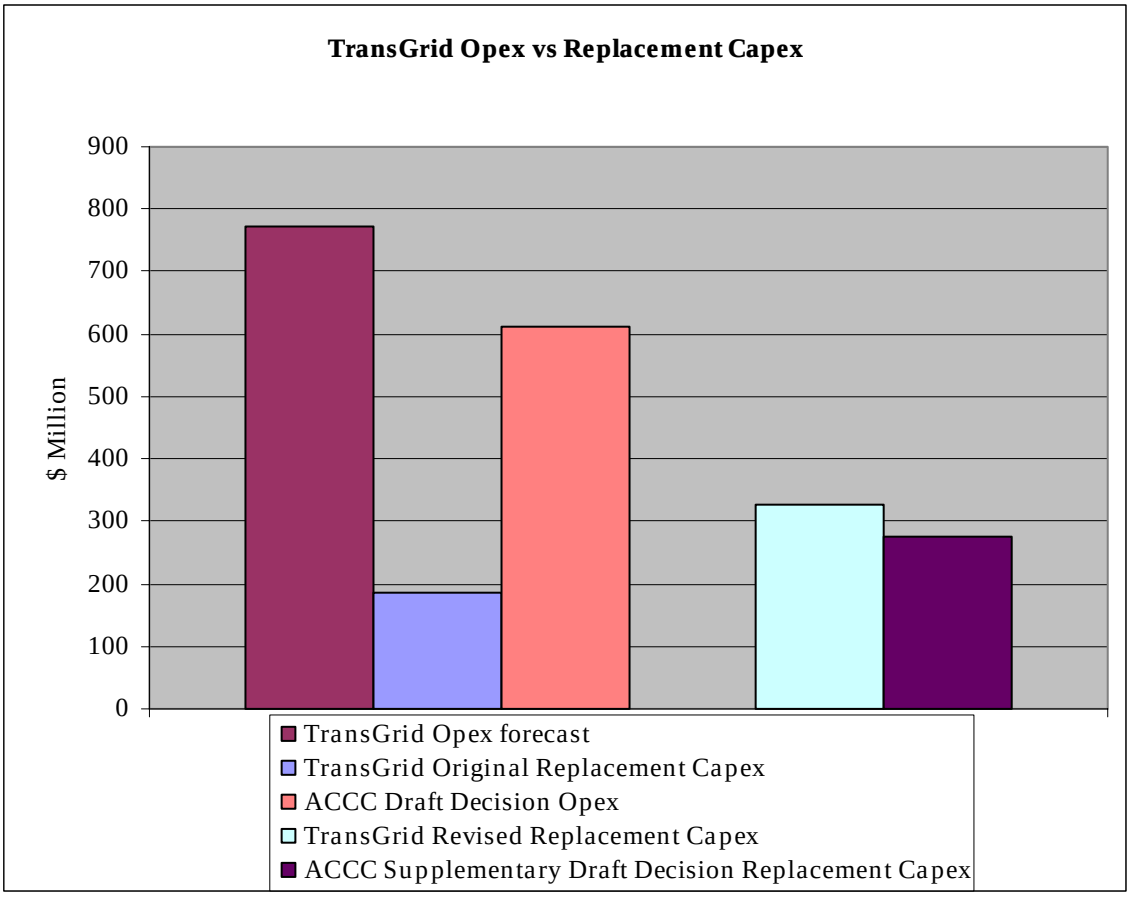
This 'rule' should hold true in both directions. That is, as capex increases and old assets are replaced, as significantly provided for in this determination, there should be a corresponding offsetting reduction in opex. However, this is not the case. Not only is it not the case, but there is no explanation as to why it is not the case. What is it about this determination that means this 'rule' does not apply? There is no explanation and this is most unsatisfactory given that customers are the ones who must pay for this.

In its original application, TransGrid's asset replacement capital costs over five years amounted to some $186 million. Based on this replacement schedule, the ACCC approved, in its draft decision, an opex of $611 million. In its revised capex application, TransGrid's replacement costs have increased to $326 million. Yet, no change was made to its forecast opex as shown in Figure 5-1 to reflect the increased replacement of old or worn assets. In the supplementary draft determination, the ACCC is proposing a replacement capex of $275 million, some $90 million above the original application.

Customers expect that operating expenditure would fall to compensate for the increased replacement capex. We acknowledge that the ACCC has indicated that the level of opex will be reviewed for the final decision. However, this is not satisfactory to customers as they will have no opportunity to scrutinise the decision before it is finalised.

We therefore urge the ACCC to release another draft decision on opex based on the draft replacement capex decision prior to finalisation.

Figure 5-1 TransGrid Opex Vs Replacement Capex



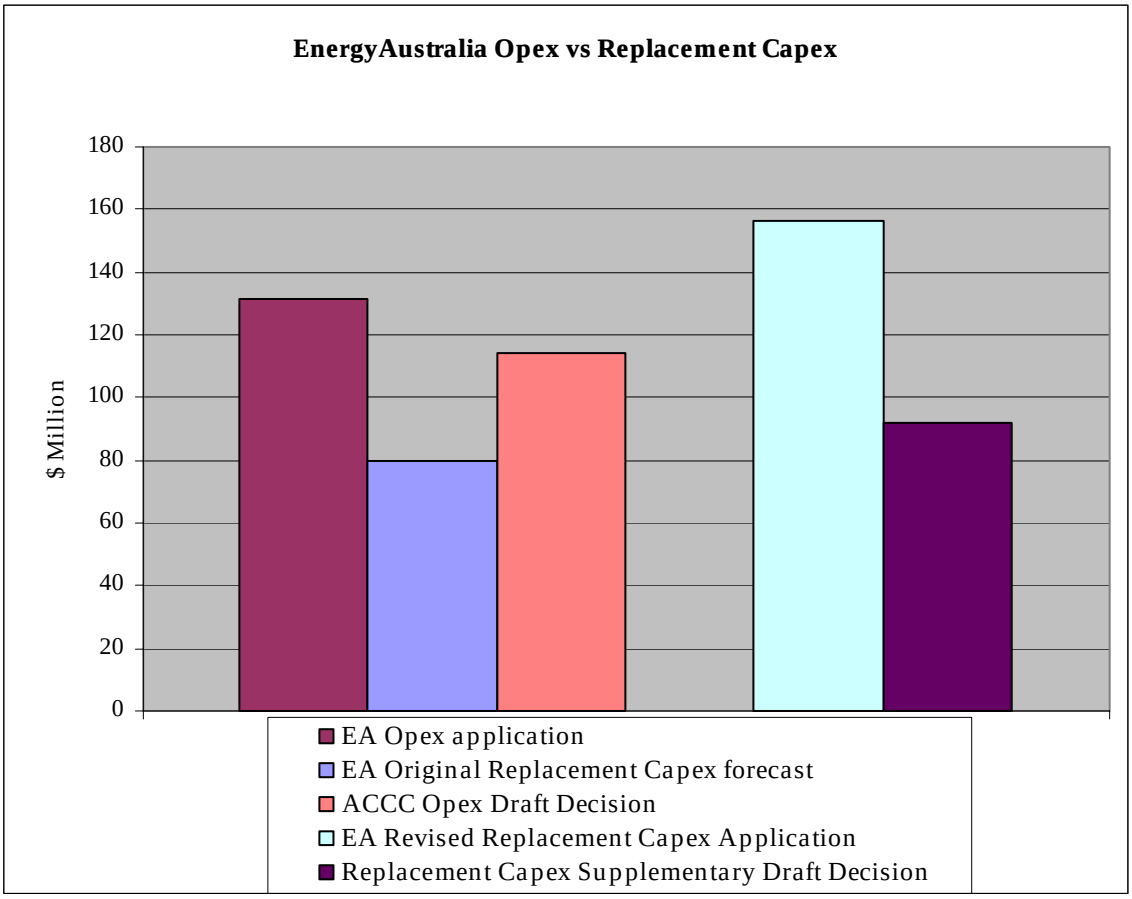
5.2 ENERGYAUSTRALIA

We acknowledge that the ACCC has raised concerns regarding EnergyAustralia's large increase in replacement capex and the practice of replacing assets before the end of their useful life. We are pleased that the ACCC has reduced EnergyAustralia's replacement capex by approximately $65 million. We however also note that the approved replacement capex still amounts to some $92 million, over 350% of the amount spent on replacement capex during the previous regulatory period and $12 million above the amount sought in EnergyAustralia's original application. As shown in Figure 5-2, no change has been made to EnergyAustralia's opex to reflect the increased replacement capex. In addition, the difference has not been explained and the ACCC should require EnergyAustralia to justify this increase, especially when EnergyAustralia claims that the increase in replacement capex would make no difference to its opex.

As with TransGrid, the ACCC has indicated that the level of opex will be reviewed for the final decision. Again, we find this unacceptable as no opportunity will be accorded to other stakeholders to comment on its views and we urge the ACCC to release another

draft decision on the opex based on the supplementary draft decision on replacement capex prior to finalisation of the decision.

Figure 5-2 EnergyAustralia Opex Vs Replacement Capex

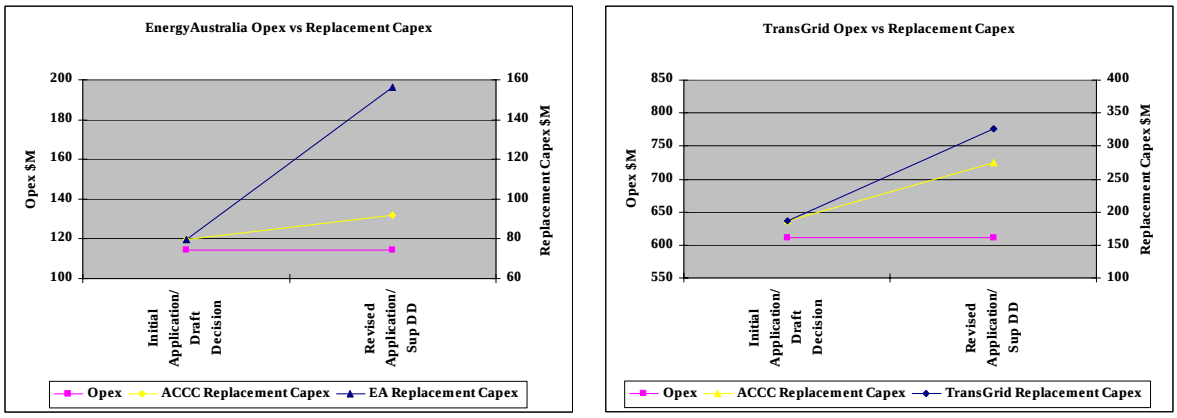


5.3 PB ASSOCIATES TERMS OF REFERENCE

It is regrettable that the terms of reference given to PB Associates did not include a requirement to determine how this increase in replacement capex from EnergyAustralia's and TransGrid's original application would have impacted on the forecast opex that the ACCC published in its draft determination. We again urge the ACCC to commission further work on this important matter before making a final determination and to ensure that such trade-offs are analysed in future transmission revenue determinations.

Our members call on the ACCC to ensure that EnergyAustralia's and TransGrid's applications for increased replacement capex are balanced by a corresponding reduction in their operating costs. Figure 5-3 shows the increase in replacement capex for both EnergyAustralia and TransGrid. Without a corresponding reduction in opex, it is highly likely that customers are being exploited.

Figure 5-3 EnergyAustralia and TransGrid Replacement Capex Vs Opex



Customers also call on the ACCC to benchmark the level of replacement capex and opex so that a set of comparable metrics can be applied to all TNSPs. At every review, it seems that both replacement capex and opex are increasing significantly. While customers are expected to pay for these expenditures, we have no way of assessing the efficiency of the TNSPs. Publishing benchmarks will at least provide us with a way of assessing the relative efficiencies and may put pressure on TNSPs to justify increases.

6 DEMAND MANAGEMENT OPTIONS IGNORED

With peak demand only occurring for a very short period of time (usually only during the hottest summer days), and being dependent on the extremity of weather conditions during summer, capital investments in network assets can be a very inefficient means of meeting peak demand growth. More flexible options are better suited to such duty. Even short-term, low capacity demand management options can defer investment for several years, leading to significant cost savings and reduce the risk of stranded transmission investments and surplus capacity.

The costs incurred in investing in capacity to meet peak demand would have to be covered during non-peak periods when such additional capacity is largely unnecessary. Peak demand growth would more efficiently be met by demand management and embedded generation where customers would be paid to reduce their demand during times of system stress. The total cost of such measures would inevitably be lower than the cost of augmenting the system to meet the limited duration when peak demand occurs.

The impact of considering only network solutions is also borne disproportionately by flat load customers who do not contribute to the peak demand problem to the same extent as peaky loads relative to their total energy consumption. These customers would still be faced with significant increases in the cost of supply while obtaining little benefit from the additional investments. With demand side solutions, some customers may at least have the opportunity of obtaining a benefit if they were paid to shed load during times of system peak demand, whilst the remainder of customers would not have to pay for the avoided investments in the capital infrastructure.

In NSW, IPART has made a determination that promotes demand management in the State's distribution network. The ACCC should also ensure that TransGrid seriously considers the opportunities for demand management instead of simply applying a network solution to meet increased demand. This would also provide for a more seamless and consistent approach to network support demand management throughout the NSW system. The recent high and volatile peak energy prices in NSW would give additional value to embedded generation and demand side response and increase the economic opportunity to reduce network investment to meet peak demand.

TransGrid and EnergyAustralia both claim that they encourage demand side management and embedded generation responses. In its 2004 Annual Report, TransGrid claims that it "*strongly supports network driven Demand Side Management (DSM) principles and practical implementation of associated projects.*" However, their original as well as the revised capex applications contain little information on how they plan to implement these programs or any details of how they evaluate demand management alternatives.

We acknowledge that there are difficulties in achieving appropriate demand side response with respect to aggregating sufficient capacity as well as the location of the resource. However, we are concerned that the incentives that the TNSPs face continue to discourage demand side response while promoting network solutions to managing peak demand growth. We note that TNSPs are rewarded based on the value of their assets. This provides an incentive to increase their asset base. Demand management solutions detract from this objective, as they reduce the need to expand the asset base. It is therefore important for the ACCC to ensure that regulatory incentives are realigned to promote demand management solutions by the TNSPs. The ACCC has consistently stated its support for demand management and now is the opportunity for it to back this up with real incentives for Transgrid and EnergyAustralia.

TNSPs should be required to provide evidence of the demand management solutions that they have considered and the attempts made to obtain demand side responses. These attempts must be serious and meaningful.

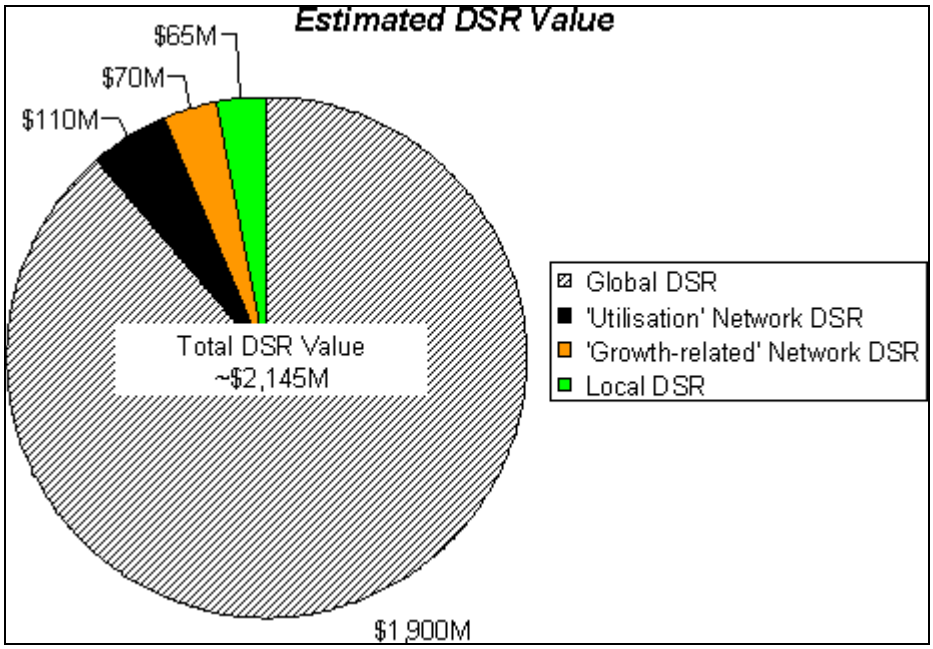
PB Associates also notes that "*with respect to DSM or grid support by generators, TransGrid is proposing nearly $1bn between 2008 and 2012 in network investment to improve the supply paths to the Sydney load centre. … If the market does not act to optimally locate new generation then, some form of support payment may provide sufficient commercial incentive deferring the need for major network augmentation*." (p. 133) This is exactly what customer groups have been advocating for some time. If TransGrid and EnergyAustralia actively support demand side response by providing sufficient support payments to customers to reduce demand during times of system stress, major network augmentation may be deferred leading to lower overall costs. Regrettably, as highlighted earlier, this is not in the interest of the TNSPs as they do not receive financial returns on such measures.

The EUAA has recently completed a Demand Side Response (DSR) trial that enabled customers to participate in the market by responding to high pool prices and system stress by bidding to shed load during such periods. It found that the system would stand to gain significantly if customers are empowered to participate in the electricity market. Trial results suggest that demand management could release up to $2 billion a year in value – or around 10% of retail turnover in the NEM. This is shown in Figure 6-1.

Although the trial estimated around $180m worth of network DSR, it is felt that the continuing growth in peak demand and the growing stresses this has placed on networks would mean that this amount has grown in the intervening period.

Whilst the trial only included distribution network support scenarios, it was recognised that there was also a role for DSR in providing transmission support.

Figure 6-1 Estimated Value of Demand Side Management



While most of the value is created in the more efficient pricing of pool energy, the value to networks (both distribution and transmission) comes from savings of:

- $60-80 million / year from the deferral of 'growth-related' capital investment; and
- $110 million / year from improving utilisation of 'sunk assets' that are currently rolled into regulatory asset bases.

As a result of our trial, over 40MW of demand side response have been signed up through a company, Energy Response. This provides a concrete demonstration that DSR can be activated in the NEM, including for network support. However, this needs a regulatory response from bodies such as the ACCC.

We urge the ACCC, at the very least, to require and / or incentivise (along similar lines as the NSW IPART decision) both EnergyAustralia and TransGrid to prove that they have in place arrangements to support demand side management by conducting trials and allocating funds to support this aspect of DSR. Energy Response is well placed to assist the TNSPs to make use of demand side management. EUAA would be keen to play a part in facilitating interest from customers and creating awareness amongst them.

7 PRICE IMPACT

Customers commend the ACCC for considering the impact of its decision on customer TUoS charges. However, we continue to call on the ACCC to assess the impact of its decision on the customer bills. It is of limited use to provide only information on average impacts, when it is well known that some customers are impacted by new TuoS charges in ways that far exceed the average impact. The ACCC still needs to pay more attention to the fact that customers are the ones that pay TuoS charges and are ultimately impacted by the TuoS charges that flow from its decisions. Greater transparency and information is called for than is provided to customers at the moment. We urge the ACCC to consider this matter before finalising this decision.

Moreover, some of the ACCC's determination in this matter may have wider implications, including impacting on the energy market. This is especially so in the case of interconnections that have the potential to reduce pool prices over the medium to long term. It is also the case with respect to new investment, which can relieve transmission constraints.

Last year the EUAA published estimates that interconnector constraints in the NEM was costing end users around $6B, based on the impact that constraints had on regional pool price differences (allowing for transmission losses). An update of this cost to customers presented by the EUAA Executive Director in his speech to the EUAA 2004 Annual Conference puts the number at $7.6B and reach $8B by the end of 2004.

We thus urge the ACCC to consider not just transmission price impacts of its decisions, but also undertake pool price studies to assess the impact of major interconnection and/or augmentation projects (including the proposed 500kV ring around Sydney and the QNI and Snowy to Vic upgrades). We would also propose that the ACCC release for public consultation the findings of these studies to allow end users to evaluate which scenario provides the best medium to long-term energy pricing and reliability outcomes.