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Mr Chris Pattas
General Manager
Network Investment and Pricing
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

ENA RESPONSE – AER DRAFT DECISION FOR TRANSGRID

Dear Chris

The Energy Networks Association (ENA) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) Draft Decision on TransGrid's transmission determination for2015-16 to 2017-18 regulatory control period, which was published on 27 November 2014. The ENA is concerned with a number of aspects of the AER's Draft Decision and provides these comments for the purpose of informing the AER's assessment of TransGrid's revised revenue proposal.

The ENA is concerned with the lack of robustness of the benchmarking analysis applied by the AER in setting a rate of change used to forecast operating expenditure. The ENA considers that benchmarking techniques such as multilateral total factor productivity (MTFP) and partial factor productivity (PFP) have serious shortcomings and are not fit for the purpose for determining expenditure allowances. Notwithstanding these concerns, the AER has used elements of its benchmarking analysis to inform its substitute forecast of operating expenditure. The ENA considers that application of the AER's proposed rate of change, as well as inappropriate consideration of step changes, risks delivering an operating expenditure forecast which has no rational basis and will lead to greater uncertainty and reduce confidence in the regulatory regime.

The ENA is concerned that the AER has relied upon EMCa's recommendations to justify a substantial reduction in replacement expenditure. Both TransGrid and its consultant AMCL have identified key issues with EMCa's analysis and concluded that analysis presented in the review does not provide sufficient evidence to support the proposed replacement expenditure reductions. The ENA is concerned that the lack of published analysis to support EMCa's recommendations indicates that the EMCa's report is inadequate for the AER to have relied upon as the detailed analysis expected to justify the recommended reductions does not appear to have been undertaken.

The ENA has significant concerns in regard to the AER's conclusions on the rate of return allowance. The approach to determining the allowed rate of return appears selective in its consideration of alternative financial models for evaluating the return on equity and artificially imposes a 'transition' to a trailing average cost of debt allowance. The ENA urges that the AER re-considers its Draft Decision approach in this area.

Furthermore, ENA is also concerned with the AER's decision to retrospectively change how it measures TransGrid's performance against the Efficiency Benefit Sharing Scheme (EBSS) targets by removing movements in provisions from the EBSS calculation. This retrospectively abandons the explicit gain-sharing framework under the regime. Such an outcome is inconsistent with fundamental principles of incentive-based regulation and the incentive features of the EBSS itself. If the AER's Draft Decision stands

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at a final decision stage, this would represent a significant departure from sound and predictable regulatory practice.

The ENA addresses each of these matters in the following sections of this submission.

ROLE OF BENCHMARKING IN TRANSMISSION DETERMINATION

The AER has used its benchmarking analysis to develop a substitute operating expenditure forecast for TransGrid. Specifically, in its annual benchmarking report the AER presented the results of multilateral total factor productivity benchmarking performed by the AER's consultant, Economic Insights. In its Draft Decision, the AER admitted the shortcoming of the MTFP analysis and has not relied on this analysis to inform its judgment on the relative efficiency of the transmission businesses. The AER stated:

> *It is difficult to draw any firm conclusions regarding the relative efficiency of the transmission networks—including TransGrid—based upon the benchmarking results in the report given the developmental nature of the benchmarking results presented.*[1]

Notwithstanding the above, the AER has used elements of its benchmarking analysis to inform its substitute forecast of operating expenditure. In particular, the AER has used the same output weights and data that informed its MTFP analysis to estimate two of the inputs to the rate of change calculation. The AER than applied this rate of change in forecasting operating expenditure using the revealed cost approach. An analysis by HoustonKemp, commissioned by TransGrid, concludes that the AER's PFP-derived rate of change is not appropriate as a basis for setting TransGrid's operating expenditure allowance as instability in the MTFP analysis also influences the AER's PFP analysis.[2]

The ENA considers that application of the rate of change, which was derived on the basis of the analysis which the AER itself characterised as 'infancy', is unlikely to deliver a robust estimate of operating expenditure requirement for TransGrid's upcoming regulatory control period.

Further, reliance on the PFP-derived rate of change led the AER to depart from the correct application of the revealed cost approach. This is because the AER did not allow any adjustments for step changes for the upcoming regulatory control period, assuming that these are captured in its forecast rate of change. In particular, the AER assumed that all legitimate and efficient step changes in costs incurred in the next regulatory control period will be offset by its PFP-derived rate of change. In doing so, the AER effectively suggested that historical step changes in operating expenditure are indicative of a business's future needs, which is unlikely to be the case. The ENA does not consider it regulatory best practice to ignore information presented in TransGrid's revenue proposal in relation to its future expenditure needs and rely on a forecast derived from historical data, noting the issues associated with the methodology which underpins this forecast.

The ENA considers that the AER's approach is inconsistent with accepted practice and lacks a rational basis. The ENA considers that application of the AER's proposed rate of change, as well as inappropriate consideration of step changes, risks delivering an operating expenditure forecast which lacks a firm rational basis and will lead to greater uncertainty and reduce confidence in the regulatory regime.

The ENA generally supports a robust use of benchmarking as one of a suite of tools and measures in responding to businesses' expenditure proposals. However, there are inherent limitations with the

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[1] AER, Draft Decision: TransGrid Transmission Determination 2015-18, Attachment 7 – Operating expenditure, 27 November 2014, p7-34.
[2] HoustonKemp, Review of the AER Transmission Network Benchmarking Study and its Application to Setting TransGrid's Opex Rate of Change, p.20.

application of benchmarking techniques in electricity transmission sector. The ENA welcomes a clear recognition by the AER that its MTFP model is at its early stage of development and should not be used to draw conclusions on the relative efficiency of transmission businesses at this point in time. However, the ENA is concerned with the AER's current approach to rely on the elements of its benchmarking analysis to inform the operating expenditure decision and urges that the AER reconsiders its Draft Decision in this area.

REPLACEMENT CAPITAL EXPENDITURE

The AER has made a significant reduction to TransGrid's proposed replacement capital expenditure. The principle drivers for a 30 per cent reduction in replacement expenditure relate to the findings of the engineering review by EMCa that was commissioned by the AER, as well as the observations drawn from the AER's trend analysis, which examined a difference in historical and forecast replacement expenditure.

The ENA has concerns that the AER has placed undue weight on the engineering review's outcomes. In particular, TransGrid has argued that the engineering review by EMCa did not sufficiently engage with the substance of its revenue proposal and the analysis presented in the review does not provide sufficient evidence to support the proposed replacement expenditure reductions.[3] In addition, TransGrid's consultant AMCL found that the review evidence was often based on misunderstandings and misinterpretations of the information provided in TransGrid's revenue proposal, particularly in relation to risk assessment processes. AMCL also found that EMCa appeared to apply distribution-focused management strategies that are generally unsuitable to transmission networks.[4] The ENA considers that the lack of published analysis to support the EMCa recommendations indicates that the EMCa's report is inadequate for the AER to have relied upon as the detailed analysis expected to justify the recommended reductions does not appear to have been undertaken.

The AER's trend analysis relies on past ten years of replacement expenditure and assumes that past replacement expenditure is indicative of a business's future needs. There are problems with this assumption as it ignores factors such as investment cycle or one-off major projects. In its revised proposal, TransGrid has argued that replacement expenditure over the last decade was below a sustainable long-term average. Therefore, it is inappropriate to draw any conclusions based on analysing expenditure over such a short timeframe as it would lead to underestimation of TransGrid's expenditure requirements. The ENA considers that this type of analysis is unlikely to provide a reasonable indication of future capital expenditure that reflects the circumstances of network businesses in the next regulatory control period. The ENA considers that the AER's final decision should include assessment of supporting evidence contained within TrandGrid's original and revised proposals in relation to replacement expenditure requirements.

REGULATED RATE OF RETURN

It is essential that network firms can earn a reasonable rate of return in order to encourage efficient investment in network infrastructure. The ENA is concerned that the AER's Draft Decision rate of return of 7.24 per cent is materially lower than TransGrid's revised proposal rate of return of 8.65 per cent. In its Draft Decision, the AER relied on its Rate of Return Guideline to the extent possible.

The network sector has a number of issues with the AER's Rate of Return Guideline which have not yet been addressed by the AER. The ENA considers that the guideline approach to estimating the return on

[3] TransGrid, Revised revenue proposal 2014/15 – 2017/18, p.42.
[4] TransGrid, Revised revenue proposal 2014/15 – 2017/18, p.42.

equity and the return on debt risks falling short of meeting the requirements the revised *National Electricity Rules*. This is because the AER's preferred methodology wrongly limits the scope of information considered to be relevant in making an estimate of the prevailing cost of equity and mandates an artificial 10 year transition to the trailing average approach for the businesses that already use a debt approach consistent with an efficient benchmark.

Further, the ENA has argued in the past that the AER's criteria, which the AER had identified as guiding the implementation of its overall rate of return approach, risks delivering the rate of return outcomes that fail to have regard to relevant evidence. There is high potential for these criteria to conflict with the requirements of the rules and lead the AER into making decisions which are inconsistent with the rules. It is the application of these criteria that lead the AER to give no weight to the Fama-French Model.

TransGrid proposed an approach to estimating the return on equity which is conceptually similar to the ENA's 'multi-model' approach. The key feature of this approach is that it genuinely considers all relevant estimation methods, financial models, market data and other evidence in determining the allowed rate of return, thereby giving effect to the rate of return provisions of the revised *National Electricity Rules*. On the contrary, the AER's 'foundation model' compromises the capacity for each piece of evidence to be given due weight through the return on equity estimation process. The exclusion of the Fama-French Model is an example of how the AER's approach fails to take relevant evidence into account. The ENA notes that the Fama-French Model is commonly used by market practitioners in making important investment decisions, as well as in academic work. The contribution of the Fama-French Model to improving predictability of stock returns has been recently recognised by the Nobel Prize Committee in its reasons for awarding the Nobel Prize for Economics to Eugene Fama. The ENA considers that this recent development is relevant to consideration of Fama-French Model and the role it should play in estimating the allowed return on equity.

In relation to the cost of debt, the ENA notes that TransGrid proposed an immediate transition to the trailing average approach. In its Draft Decision, the AER has rejected an immediate adoption of the trailing average approach. The ENA is of the view that attention needs to be given to the individual circumstances of the businesses when considering the form of transitional arrangements. TransGrid has argued that it already uses a debt approach consistent with an efficient benchmark and the AER's transitional arrangements would significantly under-compensate the business. The ENA considers the AER's approach is inconsistent with the *National Electricity Objective* as it would not allow the business to recover at least the efficient costs of debt finance, nor would it result in a return commensurate with the regulatory and commercial risks involved in providing regulated services.

RETROSPECTIVE CHANGES TO EBSS

In its Draft Decision, the AER retrospectively changed how it measures TransGrid's performance against the EBSS targets by removing movements in provisions from the EBSS calculation. In particular, the AER have calculated the EBSS carryover amounts for the 2009-14 regulatory control period by removing increases in provisions allocated to actual operating expenditure.[5] In doing so, the AER took the view that the increases in provisions do not represent the actual costs incurred in delivering prescribed transmission services when calculating efficiency gains or losses. If implemented, this decision will have a material financial impact on TransGrid.

[5] AER, Draft Decision: TransGrid Transmission Determination 2015-18, Attachment 9 – Efficiency Benefit Sharing Scheme, 27 November 2014, p9-11.

In its revised revenue proposal, TransGrid has noted that the AER's approach is inconsistent with the EBSS guidelines and also represents a departure from the AER's approach in the 2009-14 regulatory determination. The EBSS that has been applied by the AER for 2009-14 provides that:

> *In calculating the benefits or losses to be carried over, the measurement of actual expenditure over the regulatory control period must be done using the same cost categories and methodology used to calculate the forecast expenditure for that period. Adjustments will be made where necessary to correct for variances in cost categories and methodologies, and errors.*[6]

The ENA considers that this statement confirms that, as the EBSS targets were set using a provisions approach to employee entitlement costs, the performance against those targets should also be measured using the same approach.

The ENA is concerned that the AER's Draft Decision in relation to this matter effectively represents a retrospective change in the application of the scheme. This retrospectively abandons the explicit gain-sharing framework under the regime. This outcome is inconsistent with fundamental principles of incentive-based regulation and the incentive features of the EBSS itself. If the AER's Draft Decision stands at a final decision stage, this would represent a significant departure from sound and predictable regulatory practice.

If you have any questions, or ENA can be of further assistance in developing AERs views on these important issues, please contact Irina Kiparskaya, Senior Economic Analyst on 02 6272 1519.

Yours sincerely,

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[6] AER, Electricity transmission network service providers, Efficiency Benefit Sharing Scheme, September 2007, p.7.