

8 August 2014

Mr Chris Pattas  
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Australian Energy Regulator  
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By email: [transgridrevenuereset@aer.gov.au](mailto:transgridrevenuereset@aer.gov.au)

Dear Chris

**EUAA Submission on Transgrid's Revenue Proposal 2014 - 2019**

Thank you for the opportunity to make a submission on Transgrid's Revenue Proposal 2014 – 2019.

The EUAA represents many of the large energy users in Australia in the commercial, industrial and resources sector. Our members account for a significant proportion of the electricity consumed in New South Wales and the National Electricity Market.

Many EUAA members are facing significant challenges due to the rising costs of electricity and are aware that the network charges are a significant component.

Given the long term nature of investment by network businesses that is underwritten by consumers via network charges, our members value the opportunity to provide their perspective in order to assist the AER to make determinations that are aligned to the National Electricity Objective.

The EUAA are encouraged by the efforts of Transgrid to improve engagement with customers in a meaningful way. There are some significant challenges ahead and the EUAA is keen to work with Transgrid in finding better ways for the delivery of cost effective and reliable electricity.

We hope you find the enclosed EUAA response of assistance for the AER Draft Determination process and welcome further dialogue or clarification on any of the matters raised.

Yours sincerely

A handwritten signature in black ink that reads "Phil Barresi".

Phil Barresi  
Chief Executive Officer  
Energy Users Association of Australia



## Executive Summary

The Energy Users Association of Australia (EUAA) actively pursues the interests of its members in relation to energy issues impacting their business.

There is significance in the changing situation in regards to recent demand trends, forecast flattening of demand and declining energy outlook via AEMO's recent reports.<sup>1</sup> We are concerned about asset under utilisation trends. It is understood the combination of regulator approved long term network investment and reducing asset utilisation will result in an increase in the unit price of "transport" of electricity.

It is against this backdrop that the need for prudent and efficient investment and expenditure as required by the National Electricity Rules is of paramount interest to EUAA.

The key comments, concerns and issues associated with the Transgrid revenue proposal made in this submission are summarised as follows.

1. The proposed **WACC** appears to be inconsistently high compared to the value derived via the "Better Regulation – Rate of Return Guideline", recent AER transitional decisions and the Tasnetworks revenue proposal. EUAA members would like to receive information on the risks that network owners believe they face that justifies the return they seek.
2. The **RAB** is increasing in value by 20%<sup>2</sup> in an environment of virtually zero growth is a major concern.
3. EUAA expects the AER would challenge any proposed augmentation and seek opportunities to defer projects or if appropriate place in the contingent project portfolio.
4. The EUAA seeks robust scrutiny to be applied to the proposed asset replacement **capex** being a 67%<sup>3</sup> increase over expenditure during the current regulatory control period.
5. The EUAA questions the prudence of a 232%<sup>4</sup> increase in the proposed security and compliance **capex** compared to the current regulatory control period.
6. The EUAA questions the prudence of the step changes and escalators associated with the proposed 36%<sup>5</sup> increase in controllable **opex**.
7. The EUAA questions the prudence of entering into "pre-emptive" network support **opex** contracts up to 4 years ahead of the need.
8. Given the increasing and accumulated level of asset replacement, the EUAA requests clarification on the financial treatment (**return of and on capital**)

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<sup>1</sup> AEMO National Transmission Network Development Plan – 2013, AEMO National Electricity Forecast Report – June 2014

<sup>2</sup> Transgrid Revenue Proposal table 7.2

<sup>3</sup> Transgrid Revenue Proposal tables 5.1 and 5.15

<sup>4</sup> *ibid* 3

<sup>5</sup> Transgrid Revenue Proposal tables 6.4 and 6.16

regarding replaced assets.

9. The EUAA expects the AER to ensure the parameters used in the **STPIS** provide the right incentives to provide tangible benefits to customers.
10. The EUAA would support an incentive framework which does not result in any negative shift in the ratio of network charges allocated to large users and encourages demand management and energy efficiency measures.

The EUAA acknowledges the comments made by the AER in its issues paper associated with the revenue proposal in regard to pursuing many of the issues raised above.

A more detailed exploration of each of the elements of the revenue proposal and other additional commentary follows.

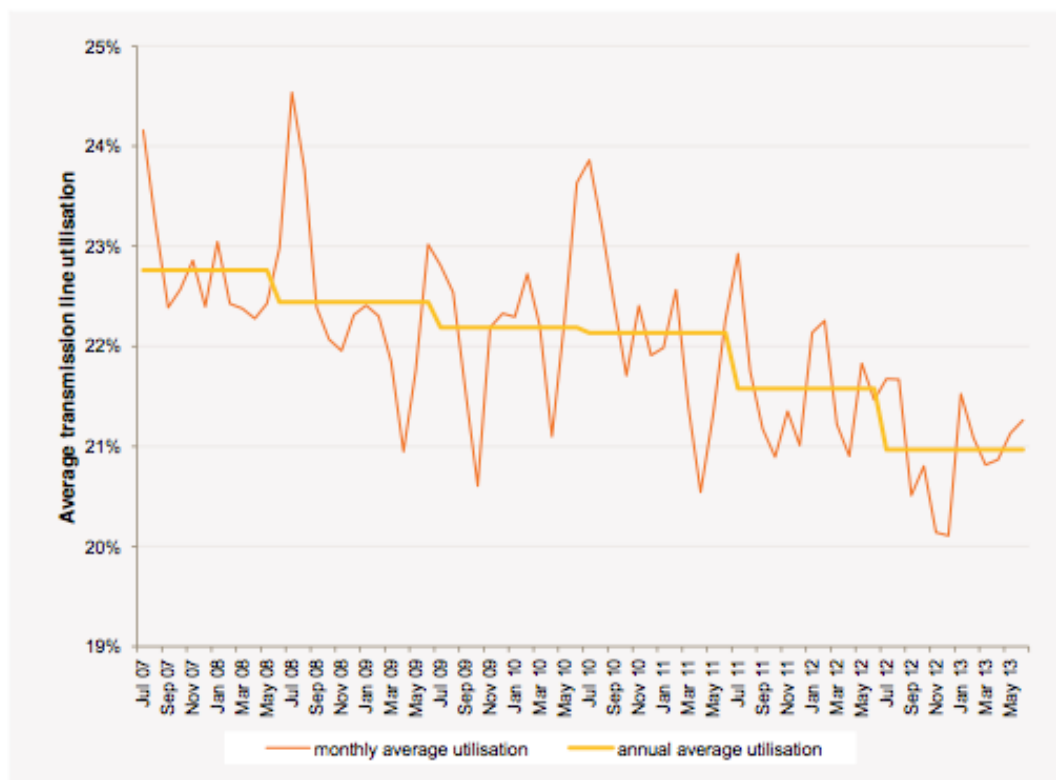
We would welcome further consultation with AER in due course.

## Introduction

Investment in the network and associated support costs is dominated by the size of the network. The size of the network is determined by the maximum demand and the reliability standards currently set by each State jurisdictional planner.

A significant factor in network charges is the degree of utilisation of the network. In other words, it is the amount of energy that is consumed as a percentage of the maximum capacity of the network. For a number of reasons included in AEMO's National Transmission Network Development Plan 2013, the utilization of networks across the NEM has fallen dramatically.<sup>6</sup>

Figure 1: Average transmission line utilisation 2007 – 2013 (Source – AEMO National Transmission Network Development Plan 2013)



The 10% POE maximum demand in NSW is forecast by AEMO<sup>7</sup> to grow by only 0.5% per annum in the short term noting this is a reduction from the 2013 forecast. The short term forecast energy consumption<sup>8</sup> is a decline of 0.07% per annum which is also reduced from the 2013 forecast. These forecasts are shown in the following diagrams.

<sup>6</sup> Source – AEMO National Transmission Network Development Plan 2013

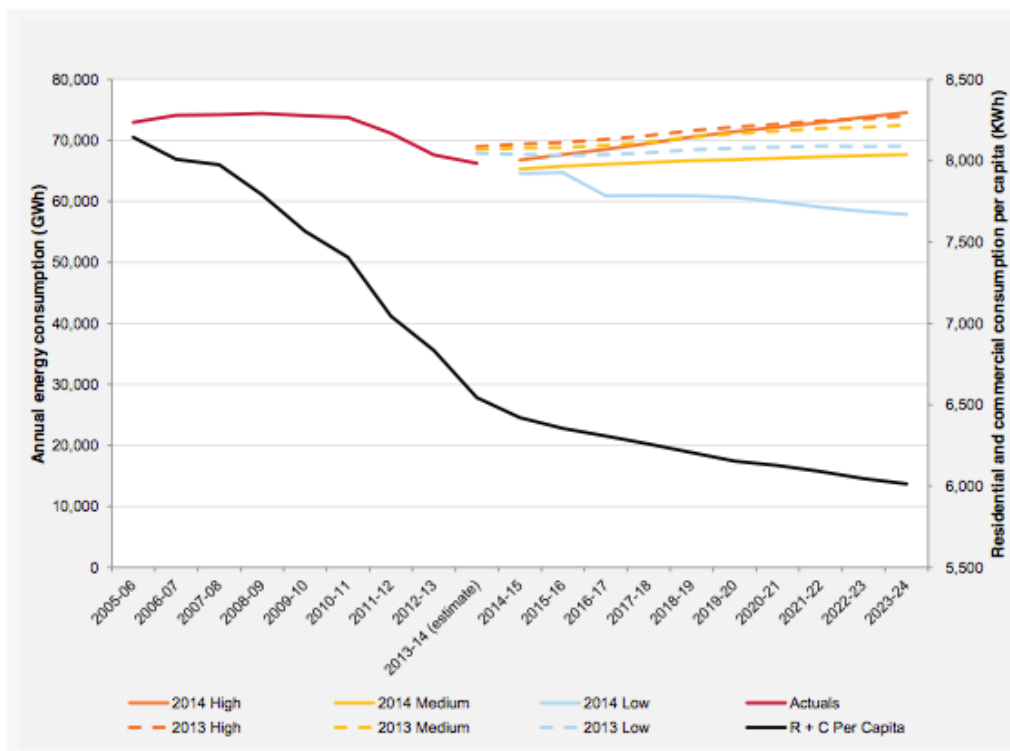
<sup>7</sup> AEMO National Electricity Forecasting Report – June 2014

<sup>8</sup> ibid 6

Figure 2: Summer 90%, 50% and 10% POE MD forecasts for NSW (source AEMO National Electricity Forecasting Report – June 2014)



Figure 3: Annual energy forecasts for NSW (Source – AEMO National Electricity Forecasting Report – June 2014)

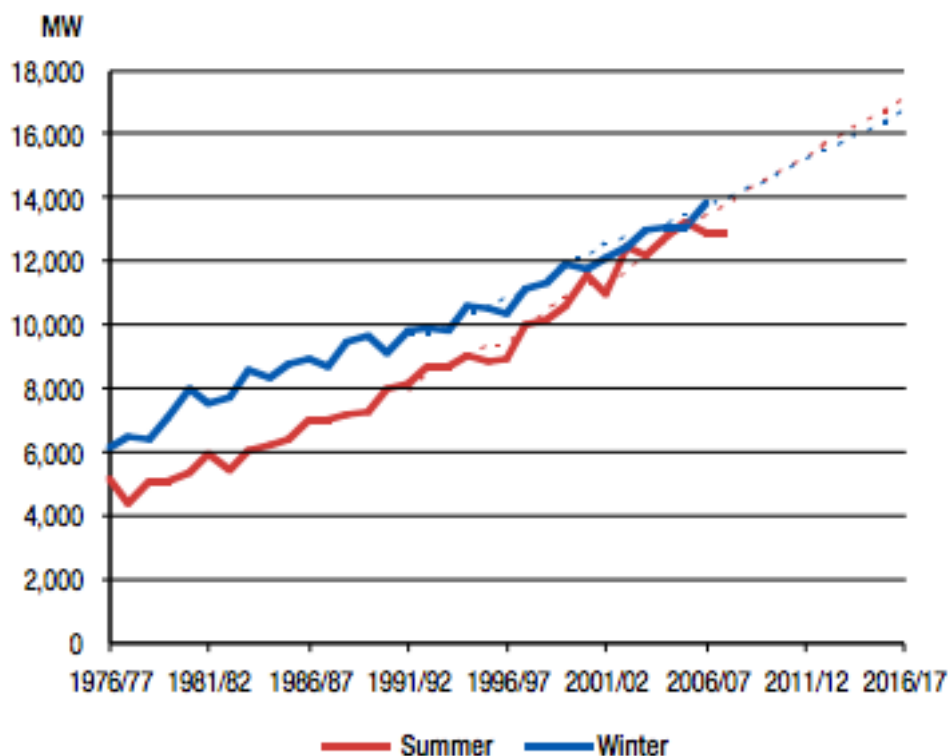


This outlook sends a message that the size of the Transgrid network business is flat for the foreseeable future acknowledging that AER approved investments to date are locked into Transgrid's revenue allowance.

It is instructive to compare the above demands to the following demand forecasts presented in Transgrid's 2009 – 2014 revenue proposal.

This suggests that the 10% POE demand will barely exceed the actual 2006/07 demand.

Figure 4: NSW peak demand growth (Source - Transgrid 2007 Annual Planning Report)



The combination of falling demand and an uncertain future in regard to economic conditions, policy, technology and customer response calls for extreme caution in regard to commitment to long term investments that add stress to business competitiveness and community cost of living.

Of concern is regulated networks business cost recovery is a "zero sum game" and that reduction in utilisation or oversized capacity is simply recovered from connected customers. Falling energy consumption will result in an increasing trend in the ratio of network charges to energy charges.

EUAA is wary of the future prospect of stranded and over capacity assets in that the current regulatory arrangement transfers all of the financial risk to customers. We would expect to see the AER have this in mind when reviewing Transgrid's proposal.

On this basis, at a high level, EUAA has the following broad expectations in terms of revenue building block outcomes.

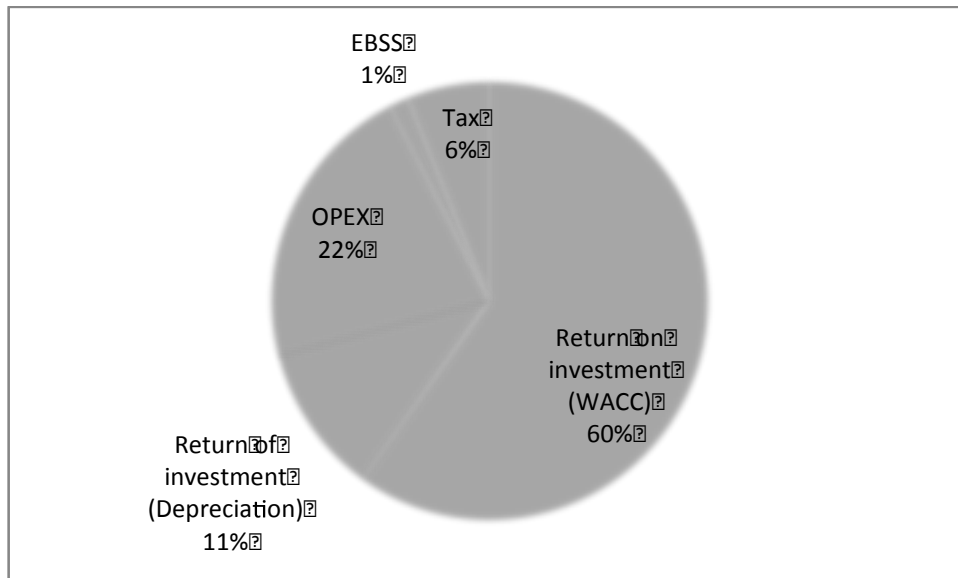
- i. All expenditure is demonstrated to be prudent and efficient.
- ii. Rate of return commensurate with regulated low risk businesses.
- iii. Very low levels of augmentation capex – limited only to localised needs.
- iv. Asset replacement capex is tested for risks and benefits from a customer and community point of view and wherever possible deferred.

- v. Other areas of capex – ie - security & compliance and support the business is no more than historic expenditure.
- vi. An efficient level of opex must be demonstrated and expenditure no greater than previous periods.

## Rate of Return (WACC)

The rate of return is a significant issue in relation to the price to customers.

Figure 5: Relativity of WACC within the MAR (Source - data from Transgrid Revenue Proposal)



As can be seen by the above chart, return on investment is the most significant portion of the Maximum Allowed Revenue (MAR).

Return on investment = WACC x RAB.

Due to the size of the Regulated Asset Base (RAB) (current value = \$6,146M)<sup>9</sup>, small changes in the Weighted Average Cost of Capital (WACC) determine large changes in MAR. As an indication, each 1% change in WACC would have more than \$60M / year additional revenue to be recovered from customers. This would equate to over \$300M during the next regulatory control period to be recovered from customers.

The EUAA has the following issues with the WACC proposed by Transgrid.

- Transgrid's proposed WACC of 8.83% is higher than the WACC proposed by Tasnetworks of 7.58%.
- Transgrid has departed from the AER "Better Regulation for Rate of Return Guidelines".
- The WACC proposed by Transgrid is greater than determined by the AER for its transition determination of 8.1%.

<sup>9</sup>Transgrid Revenue Proposal 2014/15 – 2018/19

- The proposed WACC does not reconcile with our members' view of the very low risk faced by network owners.

The EUAA is supportive of the Better Regulation program by the AER and the associated guidelines. However, we are of the view that the return on investment is generous relative to the low level of risk faced by regulated network businesses.

Further, we would seek the AER re-visits the prescriptive WACC parameters in particular the market risk premium and equity beta and provide a more balanced point allocation within the parameter ranges mooted by the AER.

## Capital expenditure

Network capital investment requires an underwriting by the customer for the life of the asset (up to 50 years).

Further, additional capex adds to the RAB, which is a major component of the total revenue.

The EUAA acknowledges the reliability standard in NSW set by the Government is N-2 for inner Sydney and N-1 everywhere else. Transgrid are obliged via their TNSP licence to meet those standards. This standard is at the highest end of reliability in the NEM and comes at a price.

The EUAA is encouraged that these deterministic standards are in the process of having a stronger economic basis in reference to page 50 of Transgrid's revenue proposal. However we would like to see this applied across all categories of capex including asset replacement.

### **Augmentation**

The proposed augmentation capex appears to be generally reflective of the forecast demand but is the forecast demand reflective of reality and does the framework have the flexibility to adjust?

EUAA expects a framework that can challenge proposed augmentation and seek opportunities to defer projects or if appropriate place in the contingent project portfolio.

### **Replacement**

Transgrid is proposing high levels of re-investment in long life assets in an environment where there is a real possibility of those investments continuing to be heavily underutilised or worst-case being stranded.

The proposed replacement program is some \$470M higher (67% increase) than the current period.

It is not clear that Transgrid has adequately considered this issue and appears to be replacing "like for like" rather than being innovative with customers to find ways to mitigate investment risk. Transgrid's response to the issue of stranded assets on page 44 of their revenue proposal:

*"Therefore, if assets progressively become stranded over 20 to 30 years, TransGrid would be able to respond by:*

- *relocating high voltage equipment to replace other equipment reaching its end of life, avoiding the procurement cost of new equipment;*



- *reusing or recycling other substation infrastructure such as steelwork; and*
- *selling property or making it available for other infrastructure such as community electricity storage."*

In the meantime, the stranded asset risk is underwritten by customers.

There is not a strong message of "only replace if there is no other option" or visibility of the real incremental risk to reliability or safety. Given the NSW reliability standard is at least N-1, what is the real reliability risk of asset failure?

The Transgrid asset replacement investment process does not appear to consider non-network solutions to offset reliability risk acknowledging the RIT-T does not require this.

The EUAA believes there should be an imperative of deferring network investment as long as possible (ie "sweat the assets") and putting more effort into strategies to minimise future asset stranding risks as the current strategies appear very cursory.

The EUAA expects the AER to adequately scrutinise asset replacement capex with consideration of at least the following:

- i. the appropriateness of Transgrid's asset condition assessment and risk management framework versus best practice methodology(eg - risk thresholds, consideration of inherent N-1 reliability, etc)
- ii. consideration of alternative options including - modifying maintenance / monitoring, non network solutions, shorter term refurbishment and other risk mitigation measures.
- iii. review the strategy of replacing whole sites / transmission lines versus asset classes. In particular review the NPV timeframes as it maybe more appropriate in this environment to take undertake shorter term / targeted projects that may appear suboptimal with a longer term NPV model.
- iv. AEMO's review of "network needs assessment" (future network requirements for major asset replacement areas) - listed in the scope of works Appendix C of the AEMO 2013 NTNDP scheduled to be published 8 August 2014.

The EUAA has some reservations of comparative benchmarks in the area of replacement based on recent Regulatory Information Notice (RIN) information or against NEM peer comparisons as they all appear to be proposing significant raising of expenditure based largely on the age "bow wave" argument and "future price shock, reliability risk", etc. The question stands: "Is this prudent for the next 5 years and what is the real risk of deferral?"

### ***Other Capex***

The areas of security and compliance are proposed to increase by \$115M over the current regulatory control period (increase of 230%).

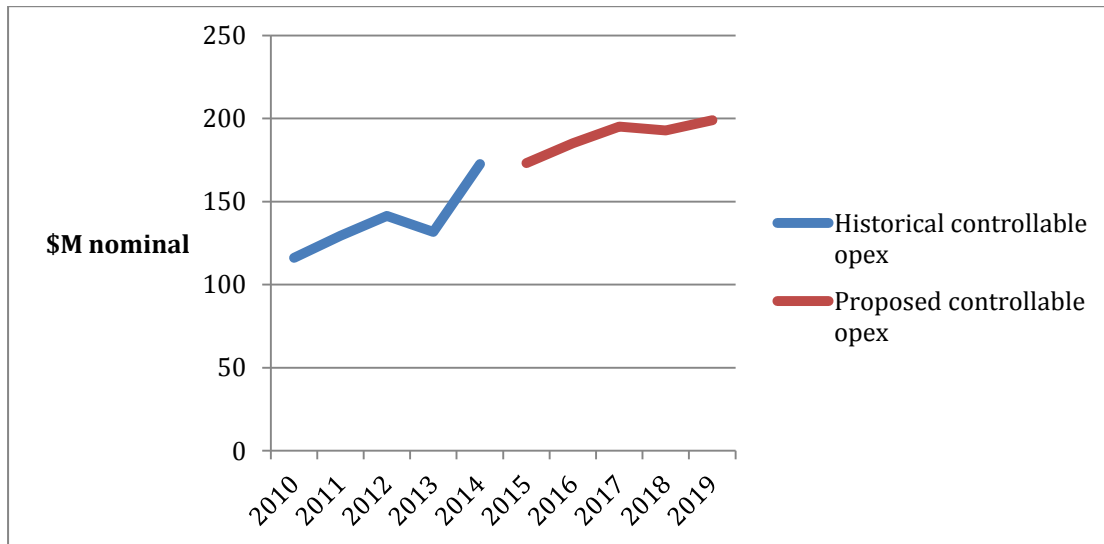
The EUAA question the prudence of the increase in security and compliance capex, in particular the risk framework applied and alternative risk management solutions considered.

## Operating Expenditure

The building block revenue model means all AER approved opex goes straight to the MAR - dollar for dollar. The majority of opex categories are recurring in nature.

As an overall comment, it is highlighted that for a business that is not growing, Transgrid seeks to increase its underlying operating costs by \$250M<sup>10</sup> (36% increase) over the current regulatory period expenditure as illustrated below.

Figure 6: Historical and proposed controllable opex (Source - Based on Transgrid Revenue Proposal tables 6.4 and 6.16)



The proposed increase is also made in the context of a controllable opex underspend in the current regulatory control period resulting in Transgrid claiming an aggregate Efficiency Benefit Sharing Scheme (EBSS) carryover of some \$52M<sup>11</sup>.

EUAA makes the observation that Transgrid proposes an adjustment to the controllable opex EBSS targets and actual controllable opex due to demand lower than forecast<sup>12</sup>.

We suggest the demand adjusted actual opex might be a good reference point for an efficient level of controllable opex.

The EUAA also have concerns about the prudence applied to some of the opex step changes and drivers and provide the following comments.

- The method of escalating maintenance costs appears to be very simplistic given the asset management expertise that resides within Transgrid.
- There does not seem to be any evidence of opex trade off for the proposed increase in replacement capex.
- The transfer of AEMO functions appears to be purely a number based on a previous revenue stream from AEMO that is now being sought to be paid for via the AER process rather than a true incremental cost.
- It would be useful to have a more visible tangible cost – benefit analysis of customer engagement and demand management expenditure. In short what

<sup>10</sup> Based on Transgrid Revenue Proposal tables 6.4 and 6.16

<sup>11</sup> Transgrid Revenue Proposal page 216

<sup>12</sup> Transgrid Revenue Proposal table 14.1

are the financial benefits to customers and when they are realised? Does Transgrid have business cases for any of this expenditure?

- Potential double counting of costs relating to new Regulatory requirements with the already large costs under Corporate and Regulatory Management.

The EUAA also questions the prudence of entering into pre-emptive network support agreements up to 4 years ahead of needs and seeks to understand industry experience in the procurement lead times of network support contracts.

We also seek to understand any fixed cost components if the forecast capacity is not required.

## DEPRECIATION

The historical and proposed levels of asset replacement expenditure beg the question of the financial treatment of assets that are replaced.

In a competitive industry, any redundant assets would be written off at depreciated value. The depreciation schedules provided by Transgrid do not indicate any write downs / accelerated depreciation which suggests that those "replaced assets" may still be included in the RAB (indexed by inflation) and earning a return in parallel with the replacement assets that have been put in service.

If this is the case, it seems an extraordinary beneficial arrangement and if allowable under the NER underscores why the regulated businesses are a low investment risk business.

## INCENTIVE SCHEMES

### ***EBSS – Efficiency Benefit Sharing Scheme***

The EUAA support the concept of the EBSS provided that the AER approved opex is prudent and efficient and that underspend can be realised by customers rather than overtaken by inflated step changes and escalators.

### ***CESS – Capital Efficiency Sharing Scheme***

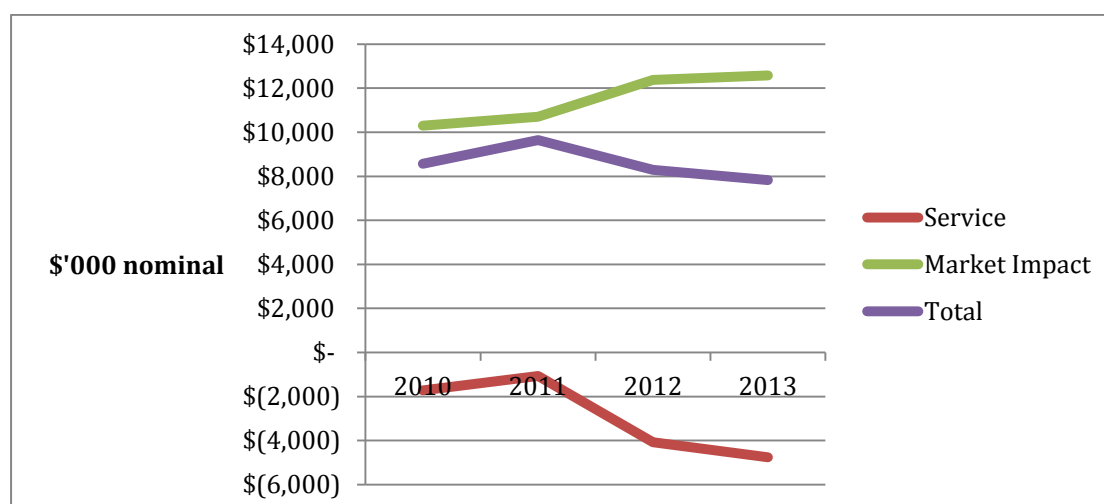
The EUAA support the concept of the CESS provided that the AER approved capex is prudent and efficient and mechanisms are in place to ensure that there are no windfall gains eg - via reductions in demand.

### ***STPIS – Service Target Performance Incentive Scheme***

The EUAA support the concept of the STPIS provided there is transparency over the setting of targets and appropriate incentive profiles such that bonuses are not paid for "business as usual" performance.

It is noted that Transgrid have achieved an aggregate of more than \$40M to date during the current Regulatory period (circa \$8M per year).

Figure 7: STPIS payment showing \$8M per year (Source - AER website)



With the introduction of the new network capability component, there is an expectation that in light of the flat demand outlook, the value of these projects are closely scrutinised with a highly tangible benefit being able to be transferred to customers (a stronger correlation to service) ideally within the same regulatory control period.

## TRANSMISSION PRICING METHODOLOGY

EUAA members experience network charges that can be a much more significant portion of the energy bill than what is apparent in residential bills<sup>13</sup>. This is further distorted with residential PV where the network charges are picked up by all other users due to energy based tariffs.

EUAA would prefer to see a smoothed approach to transmission pricing rather than a fixed price per 5 year period with the risk of a network price shock every 5 years and supports the proposed methodology of being flexible to changes in regulatory rules and an annual variation to the cap.

EUAA seeks to understand further how the proposed framework would benefit large energy customers in reducing maximum demand.

### **BENCHMARKING – PRUDENCY AND EFFICIENCY**

Transgrid has produced benchmarking metrics that place them in a favourable light to support their claim to be efficient.

The EUAA is encouraged by the statements in the issues paper on the Transgrid proposal regarding using RIN data among other types of benchmarking to provide a more balanced view. We look forward to seeing the results of the AER's assessment of NSP efficiencies in their inaugural report in September 2014.

The EUAA are particularly interested to see metrics that have characteristics including:

<sup>13</sup> AER Transgrid, Tasnetworks and Directlink – electricity determination - Issues Paper page 15

- Distinguish and focus on prudence and efficiency rather than entertaining “sales style” headlines eg – “less / within CPI”, “impact on bills is only x%”, etc
- Include costs that are in the NSP’s control
- Are not distorted by customer characteristics – eg use of energy throughput has no bearing on the cost structure of an NSP
- Are normalised where appropriate for differences between NSP’s – eg average asset age, different capitalisation policies, etc
- Is more likely to be directly comparable eg unit costs / km, etc
- Appropriate balance between self comparison (historical vs forecast) and other like companies

### **UNDER RECOVERED REVENUE**

It is understood that Transgrid have under recovered their revenue allowance.

EUAA would like to understand for completeness how this is to be applied and how it will affect the price path.