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The Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Attention Mr Paul Dunn

Dear Sir,

Please find attached a submission from the Major Employers Group in Tasmania to the Transend revenue proposal for the forthcoming regulatory period.

The MEG represents larger industries in Tasmania, which have a real interest in this matter.

We have been assisted in development of our proposal by Mr Paul Hyslop, of ACIL Tasman.

We trust the Regulator will find the submission of assistance in deliberations.

Yours sincerely

Terry Long
Chair
Major Employers Group.

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Major Employer Group (Tasmania) Submission to AER on Transend Revenue Proposal

This submission is provided to assist the AER in the review of the Transend Revenue Proposal. The submission is structured around key issues with a number of matters raised under each of these key issues.

A series of recommendations have also been made for further action or consideration of the Revenue Proposal by the AER. The recommendations are summarised here for the purposes of clarity.

Recommendations

1. That the AER defer any projects that have marginal benefits as the risk in the current economic climate is heavily on the downside.
2. That the AER and its consultants carefully review the delay in the Waddamana-Lindisfarne project to ensure:
   - any costs as a consequence of the delay were managed to the standard of good electricity industry practice (GEIP)
   - any claimed unavoidable cost increases were prudent
   - approved expenditure was not diverted to other projects simply as a consequence of the delay
3. That the AER and its consultants carefully review the 50% overrun in renewal projects in the current regulatory period, to ensure that they were warranted under the prudency test
4. That the assumptions behind Transend's maximum demand forecast be carefully reviewed to ensure that it reflects the carbon constrained environment that will be in operation over the next and subsequent regulatory periods and that exports are excluded in any augmentation assessment
5. That the AER closely assess any asset renewal projects outside the regulatory approved scope in the current regulatory period and unless a clear benefit can be proved the expenditure should be disallowed

6. That the AER exclude any renewal projects in the next regulatory period that do not have an obvious benefit
7. That the AER and its consultants closely scrutinise the Transend asset register to determine whether after accounting for general depreciation on all assets, the remaining straight line depreciation adequately covers the residual life write off of the assets that have been replaced under the renewal program in the current regulatory period and that are planned for replacement in the next regulatory period
8. That the AER closely examine the claimed operating cost increases in relation to the current and next regulatory periods to ensure that the claimed scope increases are true changes in responsibility and requirements on Transend
9. That the AER closely examine the current and proposed renewal program undertaken and proposed by Transend and apply an appropriate efficiency dividend through lower operating costs
10. That the AER consider an averaging period for the debt risk premium of two to three years rather than 10 days as it is more reflective of average financing costs that would be faced by a prudent operator
11. That the AER review the Transend land acquisition proposal to determine whether lower cost methods of accessing land could be utilised by Transend including options and dual use arrangements including reversionary rights
12. That the equity raising costs claimed should be disallowed by the AER
13. That the boundaries of the prescribed transmission service should be reviewed taking into account the large influence of hydro generation on the operation and configuration of Transend's assets
14. That the pricing methodology should cover attribution of costs to beneficiaries.
15. That the AER ensure that transmission and sub-transmission assets are considered separately and that general TUOS charges be limited to transmission assets only.
16. That revenues associated with sub-transmission assets should be charged to the specific transmission customers that are the beneficiary of such assets.

General Comments

The requirement to operate in the long term interests of electricity consumers has been cited by Transend as a basic rationale for the extent of its Revenue Proposal.

Australia is a country that is accepted by most economic commentators as being at close to full employment. It is well understood from macroeconomic theory that when economies face full employment, additional capital spending leads to inflationary pressures as well as crowding out of other investments, as competing projects seek scarce resources.

In particular, the electricity industry is facing tremendous competition for resources. The mining industry, currently in what some describe as a super cycle commodity boom, have very strong demand for the same types of resources as are required to operate and develop electricity systems.

Key skilled labour in the electricity sector is in short supply and the commodity super cycle is feeding into capital prices which have reached unprecedented levels. Capital prices in the power sector have generally increased at 20% per year over the last three years. Recent commodity price increases suggest that this cycle may continue.

It is in the long term interests of electricity consumers to avoid paying inflated prices for long dated capital assets. Recent history suggests that projects face upwards price pressures. Hence the AER should only approve projects that have obvious returns in the face of such price pressures. Similarly it is recommended that the AER defer any investments with marginal benefits as the risk is clearly heavily on the downside. The deferral should be until the case for any such investment is no longer marginal – i.e. if the benefits remain marginal the investment should not proceed at all.

Capital Expenditure

Contingent expenditure 2003-2008

The ACCC allowed Transend 362.1 million ($2008-09) over the period January 2004 to December 2009. This included the building and commissioning of the Waddamana-Lindisfarne transmission line which has suffered substantial delays and will now be completed in the 2009-2014 regulatory period.

Transend states that it will actually spend $451.5 million ($2008-09) over the current regulatory period which includes a forecast of $177.9 million for 2007-08 and 2008-09.

Referring to Table 4.2 in the Transend Revenue Proposal, based on actuals and forecast to June 2009, Transend will have spent 87.3% of its approved development capital despite substantial delays in the new Waddamana-Lindisfarne line. This warrants careful review by the AER and its consultants to ensure that:

- Any costs as a consequence of the delay in the Waddamana-Lindisfarne project were managed to the standard of good electricity industry practice (GEIP)
- Any claimed unavoidable cost increases were prudent
- Approved expenditure was not diverted to other projects simply as a consequence of the delay in the Waddamana-Lindisfarne project.

Separately Transend will have spent 149.2% of its approved capital for renewal. It is assumed that Transend had a very good and detailed understanding of the state of its assets in 2003. Assuming GEIP, it is difficult to understand how the state of those assets changed so significantly that a 50% increase in capital expenditure was required over the regulatory period. Hence the level of expenditure appears exceptionally high using the prudency test. This also warrants careful review by the AER and its consultants.

Load Forecasting

Transend have based their capital expenditure program on an econometrically determined energy and maximum demand forecasts through to 2022 – using a top down process undertaken by NIEIR supported by a bottom up survey of customers.

It should be noted that the bottom up approach does not involve commitments from customers and hence should not be given any significant weight in terms of rigour.

The forecasts adopted by Transend are for an increase in winter maximum demand of 147 MW over the six years from 2008 to 2014 which is a 2.09% compound increase per annum.

Backcasting

Transend have presented evidence of the veracity of the NIEIR forecasting because of the excellent fit of backcasting undertaken by NIEIR. While not intended to criticise NIEIR's technical prowess, backcasting proves nothing about the future. On the contrary all that backcasting proves is that the model fits the historical data. Hence little weight should be given to backcasting as veracity for future forecasting.

Carbon constraint

Table 1 sets out Transend's long term load forecasts for the period 2010-20 and 2005-40 from the Transend Grid Vision document. In the Business as usual case (no carbon constraint) the winter demand growth from 2010 to 2020 was forecast in the medium and high cases to grow 310 and 313 MW respectively. However the same document has this growth falling to 125 and 129 MW over the ten year period respectively in the case of a carbon constraint.

It is quite clear that with the introduction of the Carbon Pollution Reduction Scheme by the federal government that Australia will face a significant carbon constraint by 2010. The increased electricity prices are expected to lead to a reduction in demand. Recent work by ACIL Tasman suggests that for a $45 carbon price, demand compared to the business as usual case would fall by around 12% by 2020. The price effect is already being built into forward prices from 2010.

In addition a large portion of Tasmanian maximum demand is driven by large customers that are trade exposed to the international economy. While it is expected that trade exposed sectors will receive some compensation with the commencement of the Carbon Pollution reduction Scheme, the increased energy costs means that there is some risk that one or more of these customers will partially or fully shutdown over the next decade. This degree of uncertainty in maximum demand suggests that some weight should be given to loss of major customers in the assessment of both augmentations and renewal projects. There is no evidence presented that Transend has taken such a contingency into account.

Exported power

Transend have experienced a new Tasmanian system peak demand in the last few days of 1824 MW. However they also note that the actual transmission system peak demand (including exports)is well in excess of 2400 MW because of the volume of power exported over Basslink. This suggests that as far as the Tasmanian electricity consumers are concerned, that the Transmission system has plenty of excess capability to meet the Tasmanian system peak demand.

The power exported from Tasmania is for the benefit of consumers in Victoria, for the generators in Tasmania that are selling greater volumes of electricity and for the owners of Basslink that receive revenue from transporting this electricity. The generators and Basslink are unregulated entities that are not entitled to firm transmission capacity under the Rules. These exports should not be included in assessments that propose augmentations or renewals to meet reliability standards. Similarly where augmentations or renewals are based on market benefits tests, exports should be excluded before assessing the market benefits.

Load forecast summary

This suggests that the Transend view of forward demand is aggressive and appears based on outmoded assumptions about the environment in which it will operate over the next decade. Similarly Transend's view of the transmission systems ability to handle the demand is extremely conservative as it does not exclude exports. To the extent that any augmentation claims benefits from projected load growth beyond the five year regulatory period, errors in such assumptions will be compounded. It is proposed that the assumptions behind Transend's maximum demand forecast be carefully reviewed to ensure that it reflects the carbon constrained environment that will be in operation over the next and subsequent regulatory periods and that exports are excluded in any augmentation assessment.

Table 1 **Transend Grid Vision long term Tasmanian forecasts**

Climate constrained demand growth forecast						
	Winter			Summer		
	10% POE	50% POE	90% POE	10% POE	50% POE	90% POE
2010-20	129	125	111	107	102	98
2005-40	647	617	533	542	514	490

Business as usual demand growth forecast						
	Winter			Summer		
	10% POE	50% POE	90% POE	10% POE	50% POE	90% POE
2010-20	313	310	278	221	217	213
2005-40	1267	1221	1117	907	876	850

Difference in forecasts						
	Winter			Summer		
	10% POE	50% POE	90% POE	10% POE	50% POE	90% POE
2010-20	-184	-185	-167	-114	-115	-115
	(-58.8%)	(-59.7%)	(-60.1%)	(-51.6%)	(-53.0%)	(-54.0%)
2005-40	-620	-604	-584	-365	-362	-360
	(-48.9%)	(-49.5%)	(-52.3%)	(-40.2%)	(-41.3%)	(-42.4%)

Data source: Transend Grid Vision

Regulated asset base (RAB)

Transend has calculated the RAB opening value by rolling forward the previous regulatory period closing value which is estimated to be $987.3 million ($2009). This represents a 63% increase in the asset base over the 5.5 year regulatory period after allowing for depreciation.

Prudency of capital expenditure

Questions arise as to the prudency of the capital expenditure by Transend. Transend have expended $89.4 million in excess of the 2004-09 regulatory period approval – which is some 25% in excess of the approval. This is despite the fact that the major augmentation project – the Waddamana-Lindisfarne line suffered significant delays.

The majority of this excess expenditure appears to have been applied to asset renewal projects. Assuming the application of GEIP, Transend should have been in a strong position to understand the status of existing assets leading up to the previous regulatory period. Hence it is difficult to understand how asset renewal projects outside the regulatory approval can be justified or accepted by the AER.

It is strongly recommended that the AER closely assess any asset renewal projects outside the regulatory approved scope and unless a clear benefit can be proved the expenditure should be disallowed.

Renewal/Replacement

Over the regulatory period 2004-09, Transend are forecasting to spend 309.9 million ($2008-09) on renewal projects. These renewal projects have generally involved the replacement of existing assets. As examples, Transend:

- Replaced the Norwood-Scottsdale-Derby 88kV transmission line with a new 110 kV transmission line
- Redeveloped the Derby, Norwood and Scottsdale substations
- Replaced high voltage switchgear across 11 substations
- Redeveloped six substations which replaced transmission assets in poor condition (not mentioned whether this included the Derby, Norwood and Scottsdale substations noted above)
- Replacement of the conductor on the Creek Road-Risdon 110 kV transmission line
- Replaced three network transformers at Chapel Street substation and supply transformers at Palmerston, Risdon and Triabunna substations.

Similarly Transend intend to spend a further 226.6 million ($2008-09) in the next regulatory period.

Combining the asset renewal programs from the current period with the proposed program in the next period and using an opening RAB of $603.6 million in 2004 (inflated into $2008-09) implies that 85% of the 2004 opening asset base would have been renewed in dollar terms by June 2014.

In applying depreciation to the asset base Transend uses a straight line depreciation method with weighted average standard and remaining lives.

The very large renewal element in the current and next regulatory period and the large number of assets that have been replaced suggests that the application of the straight line depreciation method may not reflect the number of assets that have been replaced and that consequently should have their residual value written off. It should be noted that where assets are written off that they should be excised from the RAB prior to any CPI escalation with the last step being the application of straight line depreciation on the remaining escalated asset base.

It is recommended that the AER and its consultants closely scrutinise the Transend asset register to determine whether after accounting for general depreciation on all assets, the remaining straight line depreciation adequately covers the residual life write off of the assets that have been replaced under the renewal program in the current regulatory period and that are planned for replacement in the next regulatory period.

Operating Costs

Transend has applied for an increase in revenues to cover operating costs that were disallowed under the current regulatory ruling. The application is based on increased scope, wage growth and the timing of the dismantling program. Transend claim that its efficient operating expenditure increased from 33.1 million ($2008-09) in 2004-05 to 47.4 million ($2008-09) in 2008-09; a compound increase of 7.5% per year in real terms.

Further, Transend are seeking a further increase to 54.8 million ($2008-09) over the period to 2013-14; a further compound increase of 3% per year in real terms.

It is recognised that both unitised labour and non-labour operating costs are under pressure in current economic environment and hence unit costs are likely to increase above CPI.

However a review of the claimed scope changes and increases shows that they are really things that Transend would have been required to do in 2003 as a prudent operator applying GEIP. The arguments for such large cost increases are unconvincing.

Further the claimed cost increases do not appear to take account of the very large renewal program that has been undertaken by Transend in the current regulatory cycle and a similarly large renewal program proposed for the next regulatory cycle. It would be expected that improved efficiency would be a significant outcome from such a large program. This suggests that the renewal program should deliver an efficiency dividend that would manifest itself through lower operating costs.

It is recommended that the AER closely examine the claimed cost increases to ensure that the claimed scope increases are true changes in responsibility and requirements on Transend.

In addition it is recommended that the AER closely examine the renewal program undertaken by Transend and apply an appropriate efficiency dividend through lower operating costs.

WACC Inputs

The rules clearly specify the manner in which the WACC is to be calculated including setting the parameters for the debt equity split, the equity beta, the market risk premium and the debt risk premium – the latter being the margin between the annualised risk free rate and the observed annualised rate for 10 year BBB+ corporate bonds.

Transend, apparently following other parties that have been through the process, have calculated the debt risk premium based on a 10 day average leading up to its Revenue Proposal submission. Transend recognise that the AER will set the final calculation at the time of its final decision. However it is not immediately clear why such a short period is used as a matter of course.

The WACC is applied to the whole RAB. A ten year bond is used as a proxy. This by implication assumes financing for longer than the five year regulatory period. More than 50% of the RAB is already approved and hence a prudent operator would have established a portfolio of financing arrangements over several years.

A much longer averaging period would be more appropriate in order to be consistent with the financing practices of a prudent corporation facing a known financing requirement. Hence it is recommended that the AER consider an averaging period of two to three years rather than 10 days as it is more reflective of average financing costs that would be faced by a prudent operator.

It is noted that the rules do not specify the period to be used.

Land and easements

Transend have applied for land and easement charges to apply to the purchase of land and easements in 2012-13 and 2013-14. It is not clear as to the purpose of the proposed payments. However, as the purchases are scheduled for the back end of the regulatory period, some of the purchases may be for land for asset construction in future regulatory periods.

Where possible Transend should be encouraged to defer land acquisition until it is truly necessary including the use of options to secure the right to purchase land that may be used in the future. In addition, in the case of easements, Transend should be encouraged to pursue dual use arrangements with landowners in order to reduce the cost of acquisition including reversionary rights.

It is recommended that the AER review the Transend land acquisition proposal to determine whether lower cost methods of accessing land could be utilised by Transend including options and dual use arrangements including reversionary rights.

Financing costs

Transend have sought $2.4 million per annum to cover the cost of raising equity. Transend are not a listed entity and where required would be expected to have equity injected by their owner, the State Government.

While it is understandable that equity raising costs may have been allowed in other transmission company approvals, where they are privatised or publicly traded entities, this clearly does not apply to Transend.

It is recommended that the equity raising costs should be disallowed by the AER.

Attribution of benefits and costs

On page one of the proposal, Transend attribute the shaping of the Tasmanian transmission system to its hydro generation. In particular it notes that this is because of the geographically dispersed generation, low capacity generators and the seasonal variation in generation.

On page 21 of the proposal, Transend reiterate this point and highlight that the energy constrained nature of the hydro plant have a substantial influence on the configuration and operating conditions of the Transend transmission system.

These statements imply that a significant portion of the transmission system is primarily for the benefit of Hydro Tasmania. This should be reflected in the determination of the prescribed transmission system and in the pricing methodology.

It is recommended to the AER that the prescribed transmission system boundaries be reviewed in the context of Transend's claims. In addition, the pricing methodology should reflect that the hydro generation system has a major influence on the operation and configuration of the system.

Scope of services

Transend note that they are unique in that they operate sub-transmission assets down to 6.6kV. This it is argued leads to higher comparative costs with other TNSPs.

It is not clear why Transend owns and operates assets in the sub-transmission class. Such assets clearly do not form part of the meshed transmission network and should not be included in general TUOS charges applying to all customers as they tend to be specific localised assets for the benefit of localised customers. It would be inappropriate to charge costs associated with these local assets to other transmission customers.

It is recommended that the AER ensure that transmission and sub-transmission assets are considered separately and that general TUOS charges be limited to transmission assets only. Further it is recommended that revenues associated with sub-transmission assets should be charged to the specific transmission customers that are the beneficiary of such assets.