Australian Energy Regulator

Tasmanian Electricity Transmission Revenue Reset

Transend Application for Transition Year 2014/15

A response

by

Major Energy Users Inc

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Summary

The Major Energy Users Inc (MEU) welcomes the opportunity for presenting its views on the application from TransGrid for a reset of the electricity transmission costs in Tasmania for the transition year 2014/15.

The MEU is very concerned that the revenue for the transition year has been overstated. The MEU notes that this raises two very important issues:

- Community expectations are that there will be a considerable reduction in network revenues to reflect the rule changes that were introduced to achieve this outcome. If consumers do not see these reductions then there will be questions as to why the AER has not used its powers and discretions as they were intended - in the long term interests of consumers
- Even though there is expected to be a "true up" when the full review is carried out, as end user costs for capital are higher than those for regulated networks, an excessive allowance in the transition year will cause harm to end users even after a true up because of this disparity than the benefit that comes from a subsequent true up based on networks' cost of capital

Additionally, the revenue allowance for the transition year needs to reflect the reality that demand and consumption has fallen in recent years and that the revenue allowances in the current period included significant expectations of increasing demands and consumption. This means that the revenue allowance for the current period included amounts that were never needed and that there has been an over-recovery of revenue and investment in assets that was not needed.

To some extent, Transend's application for the transition year does refect these realities, in that overall capex claims are considerably lower than the capex allowances granted for the current period, and that the opex claims for the transition year do reflect very slightly lower costs. However, even with the reduced revenue claimed for the transition year, there are a number of anomalies where claims have increased significantly above costs that were actually incurred.

The MEU has assessed the WACC, opex and capex claims:

- Transend approach to WACC is not acceptable to the MEU. The approach is a mish-mash of old and new. The MEU considers that, for the transition year, the WACC approach established by the AER for SP Ausnet transmission maintains consistency and recognises that more time is needed to develop and implement the detail for the new approach to WACC development. This additional time will be provided when the detailed review is carried out under the new guidelines

- The opex claimed for the transition year appears to be reasonable. However the MEU is concerned that the full benefit of the EBSS reward for under cutting the allowed opex is being carried by the transition year. This is not appropriate

- Whilst the capex claim for the transition year appears reasonable, deeper investigation indicates that it is overstated and should be reduced by some 25%

The MEU is most concerned with the NCIPAP claim and considers that some of the projects should be carried out under the normal opex and capex programs and others should not be accepted as the benefit to cost ratio is too small or non-existent. The MEU considers that the introduction of the NCIPAP in its current form is providing networks with rewards for doing little and, in some cases, doing work that is already paid for. The AER needs to examine the NCIPAP process closely to ensure that it does not result in consumers "paying twice for the same thing" and rewarding networks for doing little or nothing. It is unacceptable to reward networks just for carrying out a project without assessing whether the <u>benefits</u> that underpinned the project are actually delivered.

The current pricing methodology provided by Transend has resulted in some considerable anomalies and a loss of equity. It must be assessed in keeping with the basic premise that each user pays its "fair share" and that prices will generally move with the AER approved yearly change in revenue.

1. Introduction

The MEU has addressed this proposal from Transend as setting the revenue allowance purely for the transition year 2014/15. The MEU will therefore focus on the revenue sought for this year to ensure that the allowance reflects an equitable basis.

Whilst the MEU would normally address forecast costs in detail based on the long term performance of Transend, it appreciates for the current purposes that such detail is probably not warranted.

1.1 The scope of this review

There is an overall view that network charges (especially those with government ownership) have risen too much over the past 6-7 years and that the network revenue rules were biased in favour of the networks. Arising from this recognition, the rules on assessing network revenues were changed dramatically to redress what has been determined as over incentivising investment in networks and providing excessive revenues to networks. It was the AER that sought the rule changes that have been implemented to address this imbalance and it is up to the AER to ensure that there is better consumer outcomes by using the discretions now embedded in the rules applying to network revenue setting.

As a result of heavy involvement in the development of the new rules and the guidelines developed by the AER to implement the new rules, consumers have an expectation that the new rules and guidelines will result in significant reductions in network revenues. If this does not occur then all of the effort devoted in the changing of the rules will have been wasted.

Ambit claims (such as provided by Transend) and front loading of costs for the transition year allowance fly in the face of community expectations. The community also expects (as occurs in competitive markets) that declining demand and consumption should result in falling prices as providers struggle to maintain market share; yet what is seen in the network claims is that declining demand and consumption results in higher prices. To achieve community expectations of lower prices, requires the networks to reduce their revenues to offset the impact of lower demand and consumption. But this has not occurred!

The transition year revenues will be the first seen by consumers since the new rules were developed so the AER decisions on the transition year allowances will be seen as a test of the efficacy of the new rules and how well the AER will use its new powers.

The AER has traditionally allowed the networks to "smooth" the prices over the regulatory period and considers that "truing up" any over payment in the transition year can be achieved with lower prices in the subsequent years. In the current environment where large electricity using firms are reducing and even ceasing operations, such a true up is of little benefit.

Over the coming year, Transend is to provide the AER with a detailed application detailing its claim for a revenue stream to apply for the entire five year period 2014/15 to 2018/19. This revenue stream will be assessed under the new electricity rules and the recently published AER guidelines.

The MEU recognises that the AER decision regarding this transition year application from Transend will only provide a "place setter" amount of revenue for the transition year. When the AER releases its decision on the detailed application by Transend for the entire 5 year regulatory period, the AER will adjust the revenues for the last 4 years to reflect any over/under allowance made for the transition year.

In theory this might be considered to mean that there is little need to get the allowance for the transition year to be as close as possible to being correct. The MEU considers that just as much care needs to be devoted to getting the allowance for the transition "right" as would apply under any other regulatory decision. This approach is based on equity. It is inequitable for users of the services in later years to be liable for errors in revenue setting for the transition year.

Whilst the setting of the transition revenue is a "place setter" subject to a later "truing up" care must be taken to ensure that the transition year revenue is still in keeping with community expectations of overall lessening of network revenues. If the revenue for the transition year is higher than it need be, then end users will incur additional costs which they will have to fund at their cost of capital. Whilst a "true up" will be carried out using the networks WACC, consumers have to fund over payments for the transition year based on the higher WACC that competitive markets achieve. This means that the penalty on consumers if the transition year revenue is set too high will be greater than the benefit from any "truing up" by the AER which is based on networks' WACCs[1].

There is no doubt that users and the services they utilise will be different in the transition year to those in the subsequent years. It would be inequitable to require a temporal cross subsidy between users where the cause is attributable to such a significant change in approach.

1.2 Transend past performance

The MEU notes that the regulatory decisions for the past two regulatory

[1] The AER has, in the past, used the networks' WACC to smooth the revenue stream but firms in the competitive market have (or should have) higher WACCs than the networks as they face greater risks. For the AER to smooth the transition year revenue will therefore not recompense end users for the additional costs they incur as a result of a higher than needed revenue allowance for the transition years

periods have massively increased Transend annual revenues: from 2003 when Transend had been allowed ~$80m (nominal) annual revenue to $247m (nominal) in 2013/14. Over the same period inflation has increased by ~35% implying that the increase in transmission revenue has more than doubled in real terms.

At the same time, neither the volumes of electricity transferred nor the quality service provided have significantly changed. Tasmanian consumers have great difficulty in understanding why the transmission costs have risen so much.

Transend is proposing only a 15% reduction for the transition year compared to the revenue allowed for 2013/14, yet the allowance for 2013/14 reflected a massive increase in its revenue over the last decade.

The proposal clearly shows that the revenue allowed for the last period was grossly overstated because Transend used over $20m pa less capex and just under $10m pa less opex than they were granted at the last review. To reflect this lower cost than allowed, Transend comments that (page 5)

> "In 2012 we made a pragmatic decision not to fully recover our maximum allowed revenue. Under that decision, we will not recover $11 million of allowed revenue in 2012–13 and $26 million in 2013–14. Customers have indicated that they appreciate the efforts we have made to curtail increases in transmission prices, and want us to do more."

The MEU is pleased that Transend made such a decision but it also notes that, whilst such a reduction in revenue was made, the reductions were less than the over-recovery Transend was achieving over the period against its lower actual opex and capex. What is more, Transend is claiming the full benefit of the Efficiency Benefit Sharing Scheme (EBSS) in the forecast revenue for its actual opex being lower than the allowed opex, further offsetting the value of the benefit of the lower revenue.

1.3 Customer and consumer engagement

Transend noted that it has increased its customer and consumer engagement and points to the meetings it has had explaining its expenditure forecasts and revenue impacts. Consultations have resulted in some planned capex being deferred and even avoided.

The MEU is pleased that this engagement has occurred but is still concerned that such interaction still consists more of "this is what we have planned" and "the reliability and availability is this and this is that it costs" rather than "how can we provide the service you need which meets your ability to pay"; reports from MEU members indicate that Transend still has the attitude of telling consumers rather than consulting with them.

The MEU recognises that the engagement process will, hopefully, improve over time, to the benefit of both consumers and Transend.

1.4 Forecasts of demand and consumption

While the energy transmitted by Transend has increased in recent years to provide energy flows to Victoria, the amount of energy used within Tasmania has remained relatively static for the last decade. In fact, as Transend highlights, domestic consumption in the state has fallen in recent years, reflecting a general trend across the NEM.

The forecast peak demand (10% PoE) of Tasmanian consumers is not expected to exceed the highest recorded peak demand in Tasmania (2008) in the next regulatory period, again reflecting a general trend in the NEM.

Based on this data, there is little expectation for a need to significantly augment the Transend network in the next 5 years but particularly there will no need to augment the network during the transition year.

1.5 The materiality of transmission costs

It is often alleged (particularly by TNSPs) that of all the costs that consumers incur from the electricity supply chain, transmission charges are the least. Other than losses and AEMO costs, this statement has validity.

However, it must be recognised that transmission costs can be a significant element of a consumer's bill, as the closer a consumer is to the transmission supply point and the larger the demand of the consumer, the more significant transmission costs can become. In fact, MEU members have seen transmission charges increase by >200% over the last 5 years! This has come against a backdrop of a continuing high currency rate exchange and tough trading conditions for trade exposed businesses. The issue that needs to be addressed is not the share of the electricity bill but the quantum of the increase. No MEU member has reported any other element in their cost structure that has risen by the amounts claimed by Transend.

It is, therefore, essential that transmission costs are <u>not</u> treated as insignificant, and are addressed in a comprehensive manner.

1.6 The helicopter view of the Transend proposal

Transend highlights that it's allowed maximum revenue was higher than its actual revenue requirements due to lower opex and capex needs and as a result it reduced the revenue it levies from consumers in 2012/13 and 2013/14 years. The MEU notes this and is appreciative of the action taken but from the MEU viewpoint, this highlights that the revenue allowed in the previous review was excessive.

Transend notes that its forecast revenue for the transition year is lower again than the actual revenue requirements for 2013/14 by about 3% in nominal terms (5% in real terms)[2]. This results in an estimated reduction in average tariff of less than 2% (nominal) and 4% in real terms. The lesser reduction in average tariff is presumably an expected lower consumption.

The import of the Transend proposal is that consumers should be pleased with what Transend is proposing. However, as noted in section 1.2 above, Transend costs have risen massively over the past decade, despite peak demand and consumption not changing significantly. So when seen in this context, the Transend proposal returns to consumers a small proportion of the increases seen over the past, yet what consumers get for this increase in revenue is little in terms of service improvement.

1.7 Escalation of costs

As the AER is only to assess the revenue allowance for 2014/15 year under the transition year process, Transend has not provided any support for escalation of opex and capex costs. Yet Transend comments (page 37) that is has:

> "…applied an estimate of forecast labour and non-labour escalation rates and inflation for the forthcoming regulatory period."

There is no detail to indicate to what extent escalation of costs has been included other than it has assumed an inflation rate of 2.5% will apply between 2013/14 and 2014/15.

The MEU considers that for the purposes, the transition year assessment should only include for expected inflation and not include for any other escalation, especially as Transend has not provided any indication as to what this "real escalation" on opex and capex might be.

[2] Compared to the allowed revenue for 2013/14, the forecast revenue for 2014/15 shows a 15% reduction in nominal terms and an 18% reduction in real terms.

2. Transend WACC and "pass through" of risk

2.1 WACC

In its transition year proposal, Transend proposes that the weighted average cost of capital (WACC) applicable to its transition year should be based on the new AER guideline. However, it is clear that the AER has not yet developed in full, the implementation details of the new approach, and neither has Transend.

This then raises the issue as to whether the AER should attempt to implement the approach *for the transition year* to WACC development under the new guideline or under the old guideline. The MEU is firmly of the view that *for the transition year only*, the WACC should be based on the methodology and parameters used most recently, such as in the SP Ausnet (SPA) transmission review and released on 31 January 2014.

It is recognised that the new guideline includes for considerable discretion by the AER and for the AER to exercise this discretion in a foreshortened review process could lead to unnecessary concerns and unintended outcomes. As the transition year allowed revenue will be adjusted for any overs/unders later in the regulatory period after the new guideline methodology has been tested within a full review process, it would be equitable to apply the historical approach to setting the WACC for the transition year.

Adopting the recent past approach to setting the WACC for this transition year should be non-controversial and, if anything, favour the regulated firm as the recent rule changes were introduced in order to bring greater balance to regulatory decision making and, in particular, to introduce a realistic methodology for assessing the cost of debt considering that the Competition Tribunal and consumers have been so critical of the AER's previous methodology.

The MEU is most concerned that Transend has elected to approach the setting of the WACC for the transition year based on a variety of inputs reflecting both the old and the new approaches and has done so in a way that results in a higher WACC than might be expected when viewing the current relatively low risk free rate. Transend has also utilised those elements of the old approach which increases the WACC (such as equity beta and gamma) and then overlaid elements of the new approach which also increase the WACC (such as a higher market risk premium).

Transend has offered a range of inputs on which to develop its WACC and these with the AER decision for SPA inputs and parameters are shown in the following table:

	Transend approach			AER on SPA
Parameter	**Lower bound**	**Upper Bound**	**Proposed**	
Risk free rate (nominal)	4.06%	4.06%	4.06%	4.31%
Market risk premium	6.50%	8.14%	6.50%	6.5%
Equity beta	0.82	1	0.91	0.8
Cost of equity	9.39%	12.20%	9.98%	9.51%
Cost of debt - 10 year BBB+ (nominal)	7.40%	7.40%	7.40%	6.79%
Expected inflation	2.50%	2.50%	2.50%	2.45%
Gearing (D/V)	60%	60%	60%	60%
Gamma	0.25	0.25	0.25	0.65
Corporate tax rate	30%	30%	30%	30%
Vanilla WACC (nominal)	**8.20%**	**9.32%**	**8.43%**	**7.87%**

The MEU considers that the only change the AER should make to their SPA assessment when applying it to Transend is to assess the risk free rate as has been previous practice and recalculate the WACC based on the risk free rate applying at the time of the final decision. The approach to the cost of debt used for the SPA electricity transmission is the most recent assessment of debt made and this applies equally to all regulated energy networks.

2.1 Pass through events

The use of “pass throughs” is a mechanism for the regulated entity to reduce its risk by passing these onto consumers. Regulators have been inclined to accept this approach as they (rightly) fear that an allowance in the costs to accommodate this risk might be too high reflecting the likelihood of exogenous low probability high impact events.

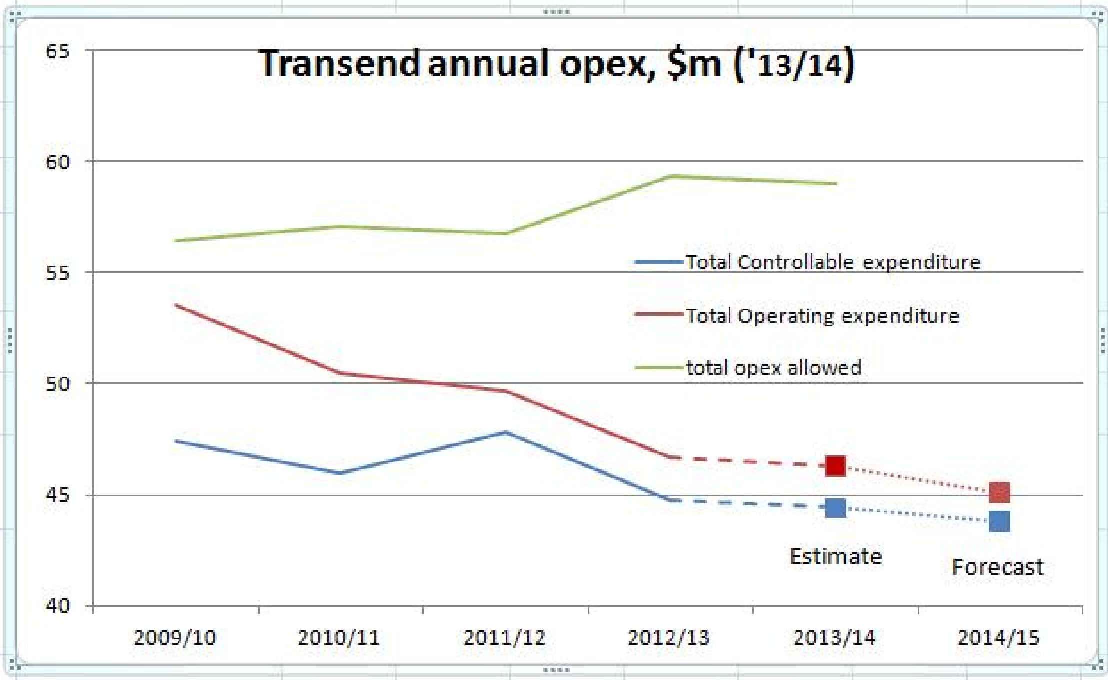
In the current Rules there are defined elements where the “pass through” of actual costs is permitted. However, it is important to recognise that in a competitive environment, the ability to pass through costs to consumers is not possible, and firms have to absorb the costs (either through insurance or directly) of any exogenous impact. Because there is the ability to pass through such costs to consumers by regulated NSPs, the AER must recognise that with this transfer of risk there needs to be a compensating reduction in the equity beta to reflect the reduced risk faced by NSPs.

The request by Transend for a pass through provision for the transition year would appear, prima facie, not to be necessary. This is because of the short period between the setting of the allowed revenue and the termination of the transition year. Further, the allowed revenue for the entire regulatory period will be set early in 2015 and there will be an adjustment made to reflect the difference between the revenue allowed for the transition year and the decision made for the revenue applicable for first year of the regulatory period under the new rules.

The revenue allowance for the transition year is a "place holder" allowance which has been developed under a foreshortened regulatory review. This precludes a detailed assessment of the conditions that would constitute a "pass through" event. On this basis, the conditions for a "pass through" should be based on the current "pass through" provisions but for these to be adjusted should there be a change made to the provisions for "pass through" when the full regulatory review under the new rules is carried out for the nest regulatory period.

3. Transend Opex and EBSS

The following chart has been developed from data in the Transend application for the transition year and the AER final decision for the current regulatory period. The chart shows that Transend is expecting the level of opex incurred in 2012/13 to be replicated in 2013/14 and the opex for the transition year to be a little less than 2013/14. The chart also shows that Transend has reduced its opex well below the allowance provided by the AER at the last revenue reset.



Source: TN application 2014, AER FD

The opex proposal by Transend for the transition year would appear to reflect the continuing downward trend in opex seen over the current period. The MEU considers that what Transend has achieved in its opex reductions is commendable and sets a reasonable estimate for opex for the transition year.

Analysis of the individual elements making up the overall opex (Transend table 4.2) shows that in most cases the allowance for each element continues the general downward trend for all opex as the claim for each element of opex is either equal to or lower than the recent past performance. Despite this, the ease with which Transend has reduced its opex over the current period indicates that perhaps even greater reductions were possible - the proposed merger of Transend and Aurora should put further downward pressure on opex due to the increased synergies.

However, it must be noted that the allowance provided at the last reset significantly overstated the opex requirement when compared to the actual performance of Transend during the current period. The opex allowance sought by Transend and allowed by the AER showed total opex increasing in real terms from 2009/10 to 2013/14, whereas in real terms, actual total opex reduced over the same years. In table 4.1 Transend shows that the actual total opex was over 15% lower than the opex allowed!

Whist the MEU supports the provision of a reward for achieving lower costs for passing onto consumers, the process its self is heavily biased by the ability of the network to "game" the regulator. For Transend to have achieved such a significant reduction in opex implies that the original allowance was grossly overstated. The fact that this point was made by consumer stakeholders at the last two revenue resets yet the excessive allowance was provided.

Under the efficiency benefit sharing scheme (EBSS), Transend is entitled to a bonus for its efforts in reducing its opex. For the revenue allowance for the transition year, Transend is targeting to recoup all of the opex under-runs for the current period as a charge to the transition year revenue. Effectively the EBSS benefit for the opex under-run in the current period (calculated by Transend to be $11.7m) has the effect of increasing the "real" opex allowance (ie the sum of claimed opex plus the EBSS which is opex carried forward from the previous period) for the transition year by some 25% and has over one third of the EBSS reward being recovered in the transition year.

If a full five year period was to be set for the payment of the EBSS, the high cost in the early years would be amortised over the entire 5 year period. As the payment for the EBSS reduces over the 5 years of the next period, it is unreasonable for the first year to be levied with the bulk of the EBSS reward.

Transend table 8.1 shows the approach to the EBSS reward being recovered.

Table 8.1 Components of the annual building block revenue requirement, 2014–15 to 2018–19 ($m nominal)

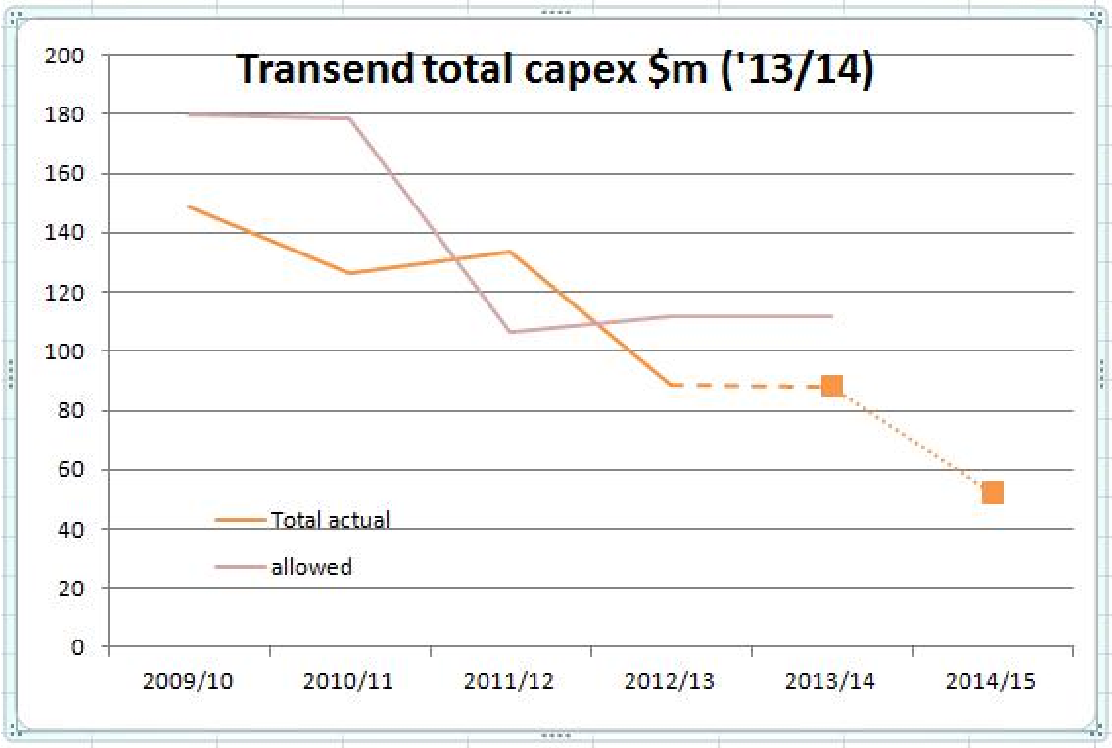
Component	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Return on capital	119.4	122.2	126.6	130.6	133.5	**632.4**
Return of capital (regulatory depreciation)	21.8	29.3	33.5	34.5	35.3	**154.5**
Total operating expenditure	47.8	48.3	49.8	51.2	51.9	**249.0**
Efficiency carryover	11.7	9.9	6.4	5.9	0.0	**33.9**
Net tax allowance	9.3	9.9	10.7	10.9	11.6	**52.4**
Annual building block revenue requirement—unsmoothed	**210.0**	**219.7**	**227.0**	**233.1**	**232.4**	**1,122.2**

The MEU considers that the EBSS reward should be amortised equitably over the entire regulatory period both directly and through the smoothing approach and not to be so heavily imposed on the first year of the period.

4. Transend Capex

Transend capex for the Tasmanian transmission system is presented in the following chart showing the actual capex in comparison to that allowed for the same period. This shows that that in four of the five years of the current regulatory period, Transend significantly used less capex than was allowed by the AER at the last revenue reset.

In aggregate terms Transend used only 85% of its allowed capex and as a result achieved a significant benefit of some $30m from this under-run in capex



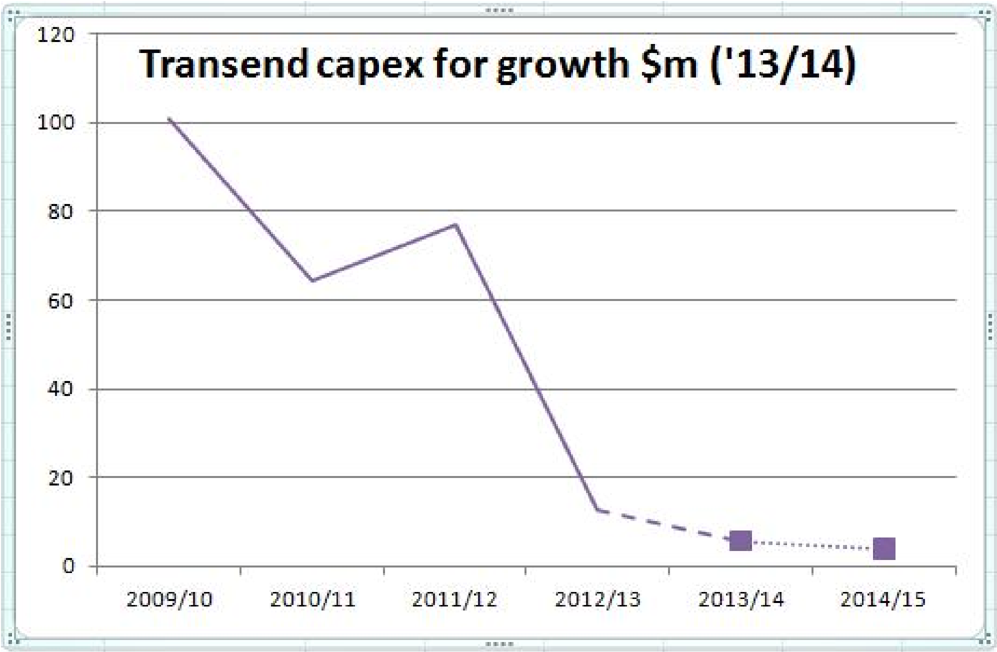
Source: **TN application 2014, AER FD**

The capex proposal by Transend for the transition year would appear to reflect the continuing downward trend in capex seen over the current period. The MEU considers that what Transend has achieved in its capex reductions is commendable and would <u>appear</u> to set a reasonable estimate for capex for the transition year.

In most cases the allowance for each element of capex continues the general downward trend shown over time where the capex claim for each element is either equal to or lower than the recent past performance, although there are exceptions such as operational support systems where the step increase (year on year) to the transition year is 225% and IT systems where the increase is 383%. There are given no reasons for such large increases raising concern that these are ambit claims.

Analysis of the individual elements of the capex shows that there is considerable variance in the historical capex and the allowance sought for the transition year. For example:

- Augmentation capex sought for the transition year (Transend table 3.2) supports a general view that there is little need for any augmentation as demand and consumption are falling. This is shown in the following chart:



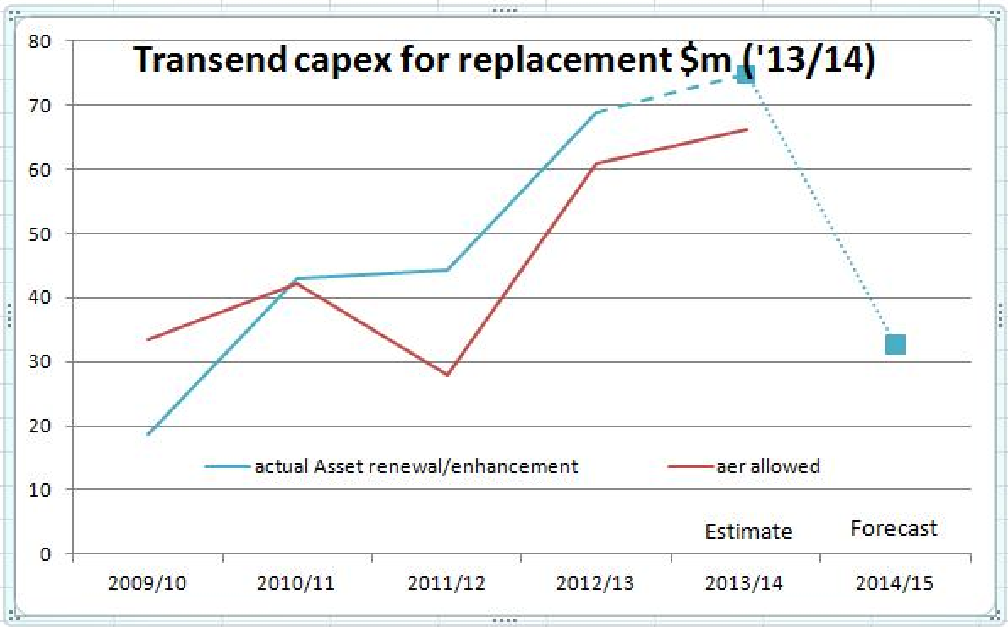
Source: TN applic

  It is also important to note that Transend had been allowed considerably more capex than it actually used for growth assets. Transend notes that it was allowed some $391.3m for growth yet only used $260.4m, mainly because the forecast growth did not eventuate.

  The MEU highlights that the bulk of the growth capex was incurred in the early stages of the regulatory period to meet the expected growth which did not occur. This means that the growth capex has provided more capacity than is currently required, supporting a view that little growth capex is needed for the transition year.

- In contrast, Transend overspent its capex allowance for renewal by some $31m (($261.1 allowed and $292.4 actual). There was also an overspend between what Transend itself forecast for renewal capex.

  The trend of renewal capex is shown in the following chart.



Source: **TN application 2014, AER FD**

By overspending on renewal capex during the current year, Transend has effectively "pre-installed" the renewal capex of $32.7m that it seeks for the transition year.

In addition, the amount of renewal capex sought for the transition year is only marginally less than the highest amount for renewal capex it indicates will be required for the entire five year period. On an average basis (assuming that Transend is awarded its indicative allowance for renewal of $140.2m for the next regulatory period) Transend is seeking some $28m pa yet it claims more than this for the transition year.

The MEU considers that Transend needs less than the $32.7m it seeks for the transition year and probably less than the average of $28m as it has already overspent its current period allowance by an average of $5m pa.

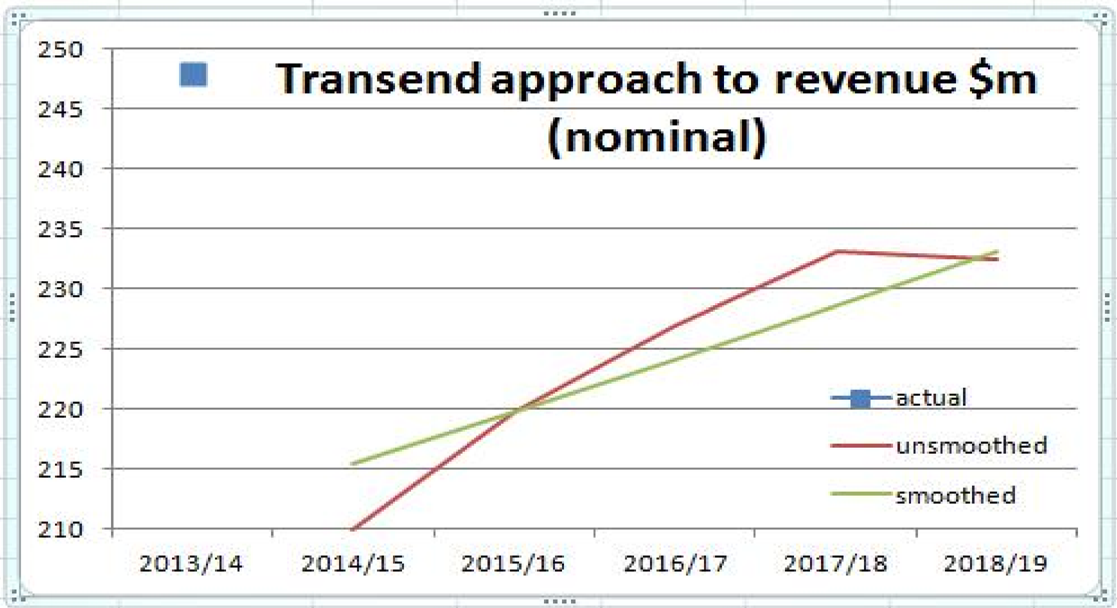
- A similar observation is made with regard to operational support system capex. Here, Transend under spent its current period allowance by 25% but is seeking a step increase from actual capex by nearly 90% for the entire period and a step increase from 2013/14 to 2014/15 of a massive 225%. As with renewal capex, Transend has heavily loaded the transition year allowance to be a quarter of the total allowance.

  The MEU notes that a similar approach has been made in relation to capex for IT where the transition year is loaded with more that its "fair share"

Overall, whilst the capex claim for the transition year appears to be reasonable, the MEU considers that it is higher than it needs be by at least $15m which implies the claimed capex is probably too high by at least 30%.

5. Revenue approach and smoothing

Transend has identified that its revenues for the next five years will be lower than the discounted revenue it is seeking for 2013/14. This is shown in the following chart



Source: TN application

What is concerning is that Transend has decided that it will smooth the revenue it seeks for the transition year to reflect a step change down coupled to a slight long term decrease (in real terms) of the revenue for the remaining four years. The outcome of this approach is that the revenue for the transition year will be artificially increased. Based on the application the artificial increase in the transition year revenue is over $5m. That is, Transend will recover $5m more than it has estimated as being the appropriate revenue allowance for the transition year alone.

There is no certainty that the AER will allow Transend either the transition year allowance assessed or the forecast revenues for the following four years under the new rules and guidelines. In fact, there is an expectation that the new rules and guidelines will reduce the revenues allowed under the old rules and guidelines - otherwise why were the rule changes needed!

The MEU considers that the transition year assessed revenue needs to be set as a stand alone estimate, not adjusted for smoothing as Transend has done. On completion of the full review under the new rules there has already been made provision for smoothing the unders/overs between the allowed transition year revenue and the revenue for the year assessed under the new rules.

There is no need for smoothing the transition year allowance as has been done by Transend.

6. NCIPAP

Transend has provided a table showing that its proposed Network Capability Incentive Parameter Action Plan (NCIPAP) will increase its revenue over the forecast five year period by an average of 1.5%.

Table A1.2 Total Network Capability Incentive Parameter Action Plan expenditure ($'000 2013–14)

	Expenditure					
	2014–15	2015–16	2016–17	2017–18	2018–19	Total ($'000)
Total Expenditure	**3,614**	**3,226**	**3,271**	**3,535**	**1,741**	**15,387**
Capex	3,389	2,994	3,024	3,274	1,474	14,155
Opex	225	232	247	261	267	1,232

The above total expenditure equates to approximately 1.5 per cent of Transend's proposed revenue.

As the MEU understands the NCIPAP, an allowance of 1.5% of revenue is a cap to include a number of small projects that could be undertaken which would deliver a clear definable benefit for consumers. For completing these projects, the network receives a reward of up to 2% of allowed revenue. As the process currently stands, there is no definable benefit that must be achieved nor must the expected benefit be measured on completion to ensure that the benefit has actually been achieved.

What the MEU finds difficult to accept, is that these projects should have been addressed by the networks under their normal capex and opex programs and it raises the simple question as to why they have not addressed these obvious needs in the past and have only now looked at them because there will be a reward.

The most common approach used by firms in the competitive sector is to assess small discretionary projects such as these on a simple pay back method – that the benefits of a project had to be recovered by savings made in 2 years (or perhaps 3 years at the most). The NCIPAP operation does not guarantee to deliver this sort of benefit (in fact there is no definition of the benefit that must be achieved). Further, in a competitive environment, if the project does not proceed there is no cost incurred. Under the NCIPAP, if the project does not proceed, there is a payment although this might be offset against the penalty, but again there is no certainty that the value of the penalty will exceed the value of not carrying out the project providing the network with a reward for doing nothing.

While the MEU supports encouraging networks to identify and complete projects that add value to consumers, the major flaw in the NCIPAP is that there is no certainty that real benefits will be delivered although there can be certainty that projects (whatever the benefit they deliver) can be delivered. This means that consumers will be paying for projects that have no certainty of delivering any benefit, let alone a commercial benefit.

The NCIPAP process is totally dependent on the network gaining agreement from AEMO that the projects identified will deliver a benefit to consumers. Transend has nominated 21 projects for the NCIPAP yet AEMO's one page letter notes that 19 have been "endorsed" as providing value for money and there is no indication of which two projects have not been "endorsed".

Transend provides a listing of its 21 projects. A review of these indicates that only half (projects 2, 6, 7, 12, 14, 18, 19, 24, 26, 28 and 31) would deliver a payback in two years and the other half would need many years to provide a net benefit to consumers. This implies that AEMO "endorsement" of projects is entirely at odds with consumers' expectations for projects such as these.

The MEU is concerned that the anticipated benefits claimed for the projects have been overstated and, as there is no requirement to demonstrate at a later time that the benefits calculated were actually achieved, consumers have no certainty that their payment for these additional works has been beneficial. What they do know is that the capital involved will be added to the RAB and consumers will pay for the capital for many years to come.

A more detailed review of each project proposed shows that many perhaps should have been addressed within the existing regulation.

For example, project #6 (priority #1) merely proposes continued operation of existing systems. The benefits would appear to be strong, yet the existing costs should be in the current opex allowance. What is more important, if this project has such a high benefit to cost why was it not included previously under the normal regulatory review process. Similar comments apply to project #7 (priority #2) and to project #24 (priority #3). It would appear that Transend is using the NCIPAP process to gain a reward for doing what it should have already implemented.

What is also obvious is that a number of projects (such as the three mentioned above) should/could have been carried out under the market impact component (MIC) incentive but presumably the rewards under the MIC were assessed as not warranting the investment to achieve these outcomes. This then reinforces the concern of the MEU that the NCIPAP approach, by not requiring confirmation that the expected benefit has been achieved, provides a biased assessment of the benefits of the projects.

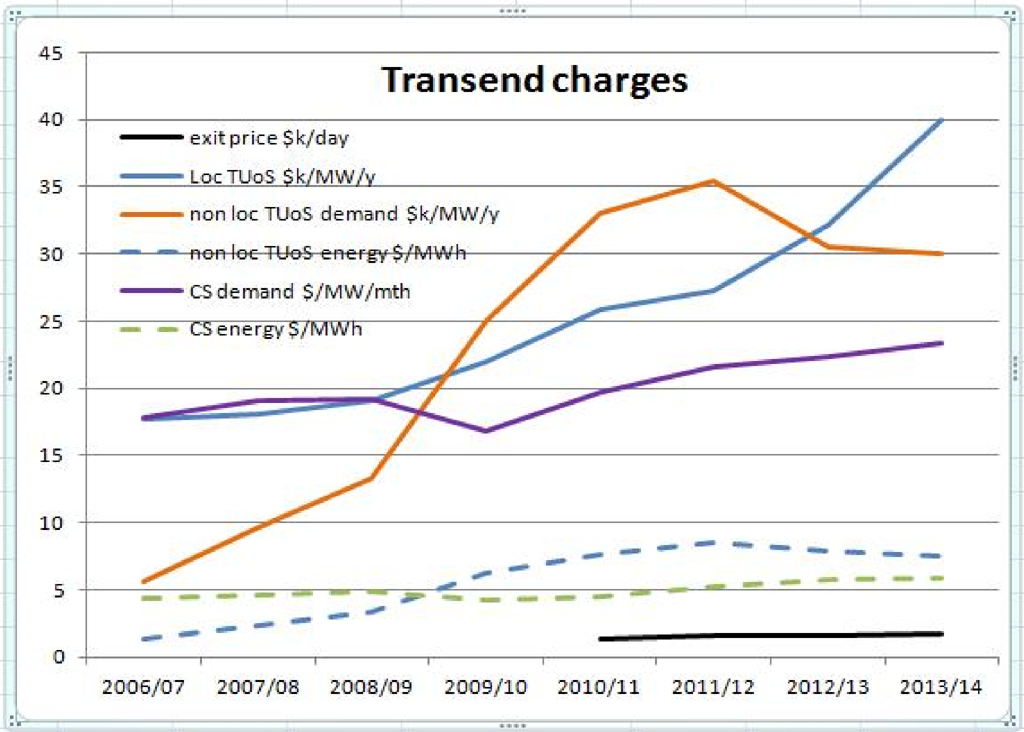
As has occurred in a number of other areas of cost claims by Transend, the costs for the NCIPAP are greatest for the transition year, indicating that Transend has again "loaded" the transition year costs.

7. Pricing methodology

The MEU is extremely concerned about the outcomes of the Transend pricing methodology. In a submission made recently to the AEMC the MEU provided the following longitudinal assessment of Transend pricing

"The MEU has tracked the Transend network prices over the past eight years. For the purposes of this exercise, the New Norfolk substation prices were recorded and the following chart shows the price movements for each element required under the rules.

At a high level, the chart reveals that there has been significant volatility in the prices for each of the individual elements over time. At the same time, consumers' expectations that prices would follow the changes in revenue allowed by the AER was not fulfilled even though this was the basis on which consumers would have forecast their future electricity cost budgets.



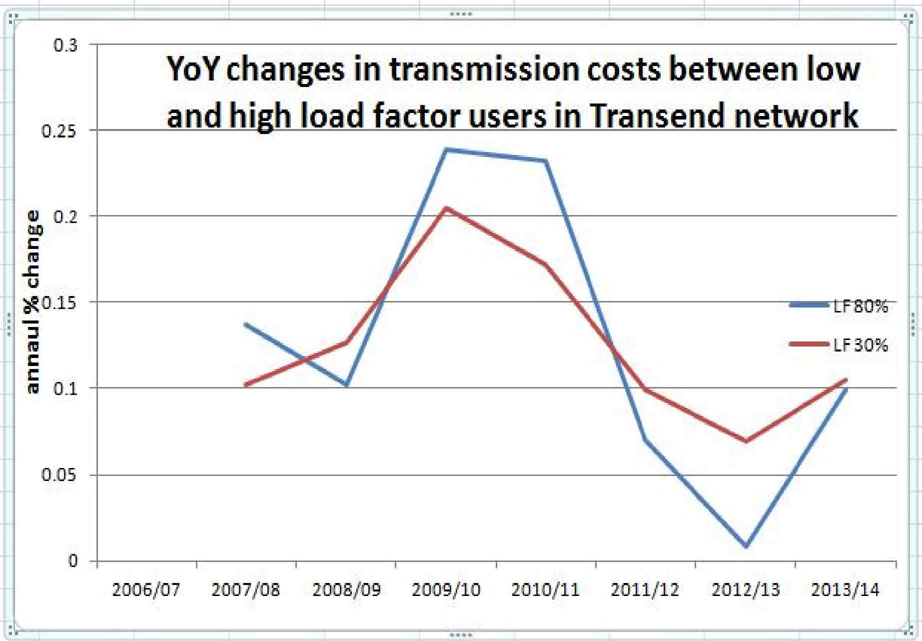
Source: Transend price lists

There are three features of the Transend pricing that should be noted.

- Whilst with the TransGrid pricing there is a loose correlation between locational TUoS and general (non-locational TUoS) with the variances explained by allocation of settlements residues, with Transend there is little correlation at all. As locational TUoS and non-locational TUoS are "two halves making a whole" there is an expectation there will be some correlation, yet this does not occur in the Transend pricing.

- Whilst there is an expectation that the year on year changes in prices for Common Services and General (non-locational TUoS) when priced on an energy basis would closely correlate with the changes in prices for these services levied on a demand basis, this does not occur. Analysis of the year on year differences between the charges made on an energy basis and a demand basis shows that the differences between the two were as high as 10% points. With such a large variation, this means that cost recovery is being biased between high and low load factor users.

  This is shown in the following chart where the year on year changes in transmission costs for a high load factor user (80% load factor) transmission costs are compared with costs for a low load factor user (30% load factor)[3] despite both having the same demand.



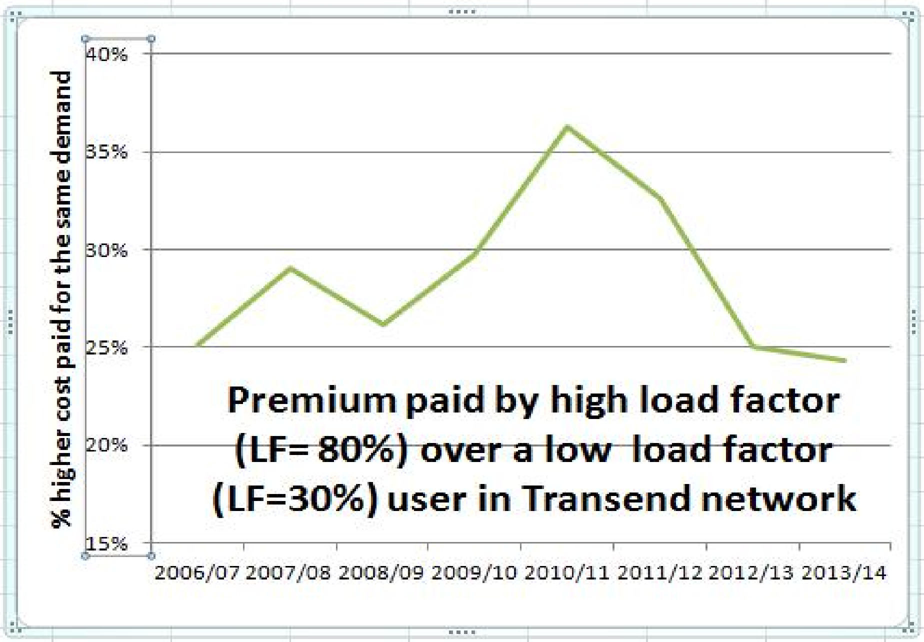
Source: Transend price lists, MEU calculations

  This supports a view that cost reflectivity is not being applied because the swings for high load factor users are more volatile than that for low load factor users as the high load factor user would have a much more predictable load and therefore exhibit more predictability in revenue.

  A similar outcome is seen in the case of TransGrid but is less pronounced

[3] The high load factor is typical of any one of the five largest users in Tasmania and the low load factor is the typical load factor on a state wide basis when the high load factor users are excluded.

- The issue of the load factor goes further. Using the same exit point (New Norfolk) and costing transmission for two users with the same the same demand but different load factors (80% and 30%), the high load factor user pays a considerable premium for transmission services and this premium is shown in the following chart.



Source: Transend price lists, MEU calculations

The chart shows that the pricing clearly discriminates against the high load factor user because of the ability to pay for general (non-locational TUOS) and common service (whichever is the lower), despite both users having the same demand. As transmission assets are sized to meet the peak demand at any exit point, the transmission cost should be much the same for the same sized demand. This clearly does not occur under the Transend approach to pricing.

What is also concerning is that the premium varies considerably year on year with a general premium being some 25% but reaching above 35% at times. This volatility is not expected and should be more stable if pricing reflected the costs incurred in the service provision.

A similar outcome is seen in the case of TransGrid where the premium paid by the 80% high load factor user rises from ~18% in 2006/07 to ~26% in 2013/14 over that of the 30% low load factor user."

The MEU is extremely concerned that Transend pricing does not reflect the costs for the service provided. The AER has an obligation to ensure there are no anomalies in network pricing through the pricing methodology approved but the outcomes do not support this requirement.

The MEU accepts that in the foreshortened review process for the transition year, it will be difficult to investigate the reasons for such variation as have been seen. Equally, consumers expect that prices will be equitable and will generally track the AER approved revenue allowances. It is not acceptable for such significant inconsistencies to be allowed to continue.