Rio Tinto Alcan

TRANSEND TRANSMISSION REVENUE CAP 2009/10-2013/14

SUBMISSION BY RIO TINTO ALCAN

TO THE AUSTRALIAN ENERGY REGULATOR

A. INTRODUCTION

Rio Tinto Alcan (RTA) owns and operates an aluminium smelter at Bell Bay in Northern Tasmania. We are a major stakeholder both in Tasmania and the Tasmanian electricity market, with take or pay power contracts to 2014 for 322 Megawatts. As Tasmania's largest electricity consumer, the Bell Bay smelter consumes more than 25% of the State's electricity demand.

RTA is pleased to make this submission on Transend's revenue proposal for its 2009/10 to 2013/14 transmission revenue cap under the *National Electricity Rules* (**NER**).

Transend's revenue proposal, in its current form, would have a significant impact on RTA's energy supply costs. Transend has acknowledged that, unchallenged, its revenue proposal would result in an increase of approximately 70% over the next regulatory period. This demonstrates that RTA is not merely an interested observer in this process. Transend's revenue proposal will have a direct and material financial impact on RTA.

As a producer of a commodity product, traded on a highly competitive, global market, RTA is a price taker and therefore has little capacity to pass these increased costs on to its customers. In contrast to Transend, it does not enjoy the benefit of contingent projects, capex re-openers, or a statutory right to pass certain costs through to its customers.

As an aluminium smelter, operating continuously 24 hours a day/ seven days a week, a secure and reliable electricity supply is of critical importance to RTA. However this requirement needs to be delivered in an efficient and cost effective manner. Excessive transmission charges, resulting from poor planning and unjustified expenditure, are also a serious threat to RTA's ability to remain competitive in the global market. Transend is responsible for operating and managing the transmission system in a manner that is both prudent *and* efficient. It cannot be allowed to justify its revenue proposal simply by claiming that its expenditure is necessary to ensure system security.

In light of this, RTA urges the AER to rigorously assess Transend's proposal against the requirements of the NER. While the changes to the rules governing transmission revenue regulation made by the AEMC in 2006 have weakened the AER's ability to control a TNSP's revenue requirements, there remain areas in which the AER has the ability to review and correct aspects of Transend's revenue proposal where these are excessive, particularly in relation to past capex, forecast capex and forecast opex.

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RTA's submission consists of three parts:

Part A – Introduction

Part B – Comments on specific issues arising out of Transend's revenue proposal

Part C – Comments on general issues arising out of the NER and the process.

RTA would be pleased to provide any further information that may assist the AER. RTA may wish to make additional submissions as further issues become public or following the AER's draft decision.

B. SPECIFIC ISSUES ARISING OUT OF TRANSEND'S REVENUE PROPOSAL

FORECAST CAPEX

1. CAPEX ASSOCIATED WITH GENERATION AND BASSLINK

1.1 The NER provides that forecast capex must be for expenditure that is properly allocated to prescribed transmission services. Capex that relates to negotiated transmission services cannot be rolled into Transend's RAB. The AER must satisfy itself that none of Transend's forecast capex relates to negotiated transmission services. The relevant requirements of the NER are set out below.

1.2 A person wishing to establish or modify a connection to a transmission network (including an existing connection) must follow the process and procedures in cl 5.3 of the NER.[1] Such a person is a "*Connection Applicant*". A Connection Applicant includes a Generator and a Market Network Service Provider (**MNSP**). Basslink is a MNSP.

1.3 Clause 5.3.6(i) provides that an offer to connect must conform with the access arrangements set out in cl 5.4A. Clause 5.4A(f) provides that:

> *"The Transmission Network Service Provider and the Connection Applicant must negotiate in good faith to reach agreement as appropriate on:*
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> *(1) the connection service charge to be paid by the Connection Applicant in relation to connection assets to be provided by the Transmission Network Service Provider;*
>
> …
>
> *(3) the use of system services charge to be paid:*

[1] cl 5.3.1(a)

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i) by the Connection Applicant in relation to any augmentations or extensions required to be undertaken on all affected transmission networks and distribution networks".

1.4 "*Negotiated transmission services*" are defined in Chapter 10 of the NER as including:

"(b)connection services that are provided to serve a Transmission Network User, or group of Transmission Network Users, at a single transmission network connection point, other than connection services that are provided by one Network Service Provider to another Network Service Provider to connect their networks where neither of the Network Service Providers is a Market Network Service Provider; or

(c) use of system services provided to a Transmission Network User and referred to in rule 5.4A(f)(3) in relation to augmentations or extensions required to be undertaken on a transmission network as described in rule 5.4A."

1.5 A "*Transmission Network User*" includes:

(a) a Generator whose generating unit is directly connected to the transmission network; and

(b) a Network Service Provider whose network is connected to the transmission network.

1.6 The effect of these provisions is that capex relates to a negotiated transmission service if the expenditure relates to:

(a) connection services supplied to a Generator or a MNSP, including expenditure on connection assets; or

(b) the augmentation or extension of a transmission network as a result of an application to establish or modify a connection by a Generator or MNSP.

1.7 Clause 6A.6.7(b)(2) provides that a TNSP's forecast capex must be for expenditure that is properly allocated to "*prescribed transmission services*." A "*prescribed transmission service*" (as defined in Chapter 10 of the NER) does not include a negotiated transmission service. This means that Transend cannot include in its RAB capex that relates to any of the matters described above. It is vital that the AER ensures that such capex is not included in Transend's forecast capex allowance. This is significant given that Transend claims there may be a need to reconfigure its network as a result of increased hydro or wind generation. An augmentation or extension to the transmission network as a result of new generation cannot be included in Transend's RAB.

1.8 While none of the capex projects described in Appendix 17 are described as being driven by Generator connections, RTA urges the AER to carefully review Transend's forecast capex to ensure that the allowances sought by Transend are properly allocated to prescribed transmission services.

1.9 This issue appears to have greater significance with respect to the contingent projects described in Appendix 18. Several of these projects appear to be driven by predicted generation developments that may result in a need to augment the transmission network, specifically:

Contingent Project	**Cost**
Sheffield-George Town new transmission line	$147 million
Burnie-Smithton new transmission line	$85 million
Sheffield-Farrell new transmission line	$80 million
Sheffield-Burnie new transmission line	$77 million
Palmerston-Sheffield 220kV transmission line augmentation	$22 million
Total	**$411 million**

1.10 The construction of connection assets or the augmentation or extension of the network as a result of the connection of a Generator or MNSP cannot be rolled into Transend's RAB, and is therefore not eligible to be approved as a contingent project under cl 6A.8.1. The AER should not approve these projects as contingent projects unless it is satisfied that this expenditure will relate to prescribed transmission services.

2. CONTINGENT PROJECT TRIGGERS

2.1 Appendix 18 to Transend's revenue proposal describes each of its contingent projects and specifies the trigger for each project for the purpose of cl 6A.8.1 of the NER.

2.2 RTA submits that these trigger events are not "appropriate" within the meaning of cl 6A.8.1(b)(4). The triggers are expressed in vague and subjective terms. For example:

- five of the projects have triggers that refer to "*Generator and/or load flow changes … leading to successful application of the regulatory test*";
- two of the projects have triggers that refer to "*Demand growth … leading to successful application of the regulatory test*";
- the Queenstown transmission security upgrade refers to "*successful application of the regulatory test*".

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2.3 The only project that has an objective element in its trigger is the St Helens new 110/22 kV connection site. This trigger includes a reference to "a DNSP application to connect".

2.4 With the exception of this final project, the trigger events proposed by Transend are not sufficiently specific or capable of objective verification. Each of these triggers can be reduced to a requirement that the project satisfies the regulatory test. Since each of these projects will need to satisfy the regulatory test in any event (each one being a "new large network asset") this effectively means there is no trigger at all. Subject to compliance with Chapter 5 of the NER, the progression and timing of the contingent project would be a matter entirely within the control of Transend.

2.5 RTA submits that these triggers should be rejected by the AER and replaced with triggers that are specific and objectively verifiable. In particular, the triggers should specify the degree of Generator and/or load flow change or demand growth that is required in order to trigger the contingent project.[2]

3. BASIS OF CAPEX FORECASTS

3.1 Transend is forecasting $680.7 million (in 2008/09 terms) in capex over the coming regulatory period, plus a further $509 million in contingent projects. This is a massive increase on the $451.5 million (in 2008/09 terms) in capex that Transend expects to commission in the current period. The AER should carefully review both the cost and timing of this capex program.

3.2 In particular, the AER should have regard to the fact these forecasts have been prepared at the height of the current economic cycle. For example, Transend's capex forecasts assume there will continue to be strong growth in labour costs, land values and non-labour construction costs.[3] There must be doubt as to whether these costs will continue to escalate in what is expected to be a slowing economy. Even if the effects of a slowing economy will not be observed in the near future, RTA questions whether parts of Transend's forecast capex could be deferred until cost conditions are more favourable.

3.3 Transend states that its demand forecasts are based on several sources of information, including "*information provided to Transend by its direct connect customers*".[4] Transend has not sought RTA's input into its demand forecasts for the purposes of this revenue proposal. The AER should not assume that the demand forecasts developed by Transend reflect the views or anticipated needs of Transend's customers.

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[2] A similar approach was taken with respect to several of the contingent projects approved for ElectraNet (*ElectraNet Transmission Determination 2008-09 to 2012-13* (**ElectraNet 2008**), Final Decision, p 134-140).

[3] Proposal, p 76-78.

[4] Proposal, p 63.

3.4 RTA notes that the introduction of an Emissions Trading Scheme (**ETS**) is a factor taken into account in forecasting both demand and generation developments.[5] While RTA supports this approach, it notes that the load growth assumed by Transend for the purposes of its forecast capex program appears to be high having regard to the fact that an ETS is predicted to result in a significant reduction in demand for electricity. The AER needs to carefully review these forecasts in determining whether they comply with cl 6A.6.7.

3.5 RTA also notes that, in light of the fact that the introduction of an ETS has been taken into account by Transend in developing its revenue proposal:

(a) the introduction of an ETS is not an event which could not reasonably have been foreseen and which could therefore justify the re-opening of Transend's revenue cap under cl 6A.7.1; and

(b) in determining whether the introduction of an ETS could justify a positive pass through, regard must be had to:

(i) the extent to which the costs of an ETS have already been allowed for in Transend's revenue cap; and

(ii) the extent to which Transend will be compensated for the impact of an ETS as a result of the cost impact of an ETS being reflected in CPI.[6]

3.6 The nature of an ETS scheme and its impact on Transend should not be regarded as uncertain. By the time of the AER's final decision (if not its draft decision) the parameters of the ETS scheme to be introduced by the Government should be known.

<u>FORECAST OPEX</u>

4. METHODOLOGY AND BASE YEAR EXPENDITURE

4.1 Transend describes its approach to forecasting opex in the following terms:

> "*the forecasting methodology adopted by Transend is consistent with regulatory best practice and broadly reflects the approach adopted by the AER in recent decisions. An implicit assumption in this forecasting approach is that the 2006–07 expenditure represents an efficient level from which to project future costs. Transend's strongly held view is that the financial incentive to minimise operating expenditure provides reasonable assurances that the base year expenditure is efficient. This inferential approach to*

[5] Proposal, Appendix 8, p 47-53; Appendix 11.

[6] It has been estimated that the introduction of an ETS will result in an increase to CPI in the order of 1%. Given that this increase will apply to the escalation of Transend's MAR, it needs to be taken into account in determining the cost to Transend of any pass through event related to an ETS.

regulation has been adopted extensively by the Essential Services Commission in Victoria."[7]

4.2 Transend's approach is consistent with the past practice of the AER to the extent that it has calculated its forecast opex requirements by reference to a base year (in Transend's case, 2006/07) although different approaches have been permitted in past decisions with respect to the selection of the base year. For example, SP AusNet based its opex forecast not on the third year of its regulatory period (as Transend did) but its fourth.[8] Giving a TNSP the ability to select the base year for its opex forecast provides it with an opportunity to manipulate the process of forecasting opex requirements by selecting the year that will produce the highest possible forecast allowance.

4.3 It should also be noted that the approach taken by Transend (and used by the AER in past decisions) is neither a requirement of the NER, nor a methodology that the AER is bound to accept. Clause 6A.6.6(d) provides that the AER must not approve a TNSP's opex forecast unless the AER is satisfied that the total forecast reasonably reflects the operating expenditure criteria. This statutory obligation overrides any policy or practice adopted in past decisions by the AER or other regulators.

4.4 With this in mind, the AER should reject outright Transend's argument that the AER should assume that Transend's actual opex for the 2006/07 financial year is efficient. Such an approach would be an abrogation of the AER's responsibility to satisfy itself of the matters required by cl 6A.6.6(c). The proper application of the NER requires the AER to consider whether Transend's actual opex for that year is an efficient and prudent starting point for the calculation of a forecast opex allowance.

4.5 While Transend does not identify the incentives which are said to ensure that its opex in 2006/07 is necessarily efficient, its argument, if accepted by the AER, would create a perverse incentive for a TNSP to overspend in a potential "base year" in order to achieve a higher forecast opex allowance in the following period. The benefits of such a strategy have the potential to far outweigh the cost of any foregone "incentives".

4.6 RTA notes that Transend's forecast opex for 2006/07 was the second highest annual opex allowance approved by the ACCC for Transend in the period 2004/05 to 2008/09. The peak in 2005/06 ($31.4 million) was due to Tasmania's entry into the NEM. In the final two years of the regulatory period, Transend's opex was forecast to decline and stabilise at around $27 million.[9] Actual opex in 2006/07 should be reviewed and adjusted to remove non-recurring expenditure associated with NEM entry.

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[7] Proposal, p 116.

[8] *SP AusNet Transmission Determination 2008-09 to 2013-14* (**SP AusNet 2008**), Final Decision, p 114.

[9] *Transend Transmission Network Revenue Cap 2004-2008/09* (**Transend 2004**), Final Decision, p 6, 72.

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5. ALLEGED "SHORTFALL" IN THE OPEX ALLOWED BY THE ACCC

5.1 Transend claims that it will spend well in excess of its forecast opex allowance over the final two years of its regulatory period. This is hardly surprising, since Transend wrote to the ACCC when its previous revenue cap was set, stating that it considered its opex allowance to be inadequate and that additional expenditure may be required.[10] While Transend claimed that this additional expenditure would be at the expense of its shareholder, the State of Tasmania appears not to have suffered under the current revenue cap. The ACCC's regulatory reports and Transend's own announcements[11] suggest Transend remains one of Australia's more profitable TNSPs, with a balance sheet "among the strongest in the National Electricity Market".[12] Transend's shareholder is sufficiently confident in the profitability of the business to transfer $220 million in debt from Hydro Tasmania to Transend.[13]

5.2 While Transend has claimed there is a "shortfall" between its actual opex and the opex allowed by the ACCC in 2003, Transend's actual opex between 2004 and 2006/07 has been relatively close to its forecast allowance. The alleged shortfall is due to the fact that Transend now claims that its opex for the remainder of the current period will increase instead of decreasing, as forecast, due to the easing of costs associated with NEM entry.

5.3 RTA urges the AER to expressly reject Transend's proposition that an increase in Transend's MAR of 9.1% in 2009/10 is justified by:

> *"an operating expenditure shortfall that arises because the ACCC's 2003 revenue cap decision provided an insufficient operating expenditure allowance for Transend to meet its obligations as a TNSP."*[14]

5.4 This appears to be an attempt by Transend to blame the ACCC for a substantial part of the 28.5% increase in the revenue sought by Transend in the first year of the next regulatory period. This proposition should be rejected by the AER. The ACCC, in 2003, established what it considered to be a prudent and efficient forecast opex allowance for Transend in the current regulatory period. As discussed above, Transend has, to date, largely operated within this allowance without compromising its financial or operational performance. This suggests that the ACCC's forecast opex allowance, established in 2003, was an appropriate forecast of required opex over the whole of the current regulatory period.

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[10] Proposal, p 43.

[11] "*Transend has Funding Capacity*" Media Release, Transend, 4 December 2007.

[12] State of the State address to Parliament by the Hon Paul Lennon MP, Premier, 16 October 2007.

[13] "*Equity Restructuring of Hydro Tasmania and Transend Networks*", Ministerial Statement to Parliament by the Hon David Llewellyn MP, Minister for Energy, 27 May 2008.

[14] Proposal, p 3.

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5.5 The AER should not simply disregard the forecast opex allowance for 2007/08 and 2008/09 approved by the ACCC in 2003. For the vast majority of businesses, the necessary and appropriate response to increasing costs is to manage expenditure to ensure it remains within the budget that has been approved. The regulatory regime under the NER should be administered so as to impose the same discipline on a TNSP. The reality is that there is no 'shortfall' in Transend's opex allowance over the current regulatory period. Rather, Transend will exceed that allowance, mostly over the final two years. Transend should not be rewarded for this overspend by having it set aside in determining the appropriate base from which to forecast its required opex over the next regulatory period.

5.6 In light of this, 2006/07 should only be used as a base year for the calculation of forecast opex for the next regulatory period if it is adjusted to have regard to the reduction in expected opex forecast by the ACCC for the final two years of the current regulatory period.

6. LABOUR COSTS

6.1 Much of the increase in opex sought by Transend has been attributed to anticipated increases in labour costs.[15] Transend has based its opex forecast on the assumption that labour costs will escalate at an average of 3.3% per annum (in real terms) between 2008 and 2013.[16] This is appreciably higher than the rates accepted by the AER for the purposes of setting revenue caps for ElectraNet (2.9% for the period 2008/09-2012/13),[17] SP AusNet (2.8% for the period 2008-2013)[18] and Powerlink (2.67% for the period 2007/08 to 2011/12).[19] The AER should consider the extent to which Transend's labour costs are inflated by the growth in the size of Transend's workforce that has occurred in recent years. It should also be noted that the forecast prepared for Transend by CEG assumed (in part) that productivity would decline over the period 2008-2014,[20] while recent decisions by the AER have assumed an increase in productivity over the same period.[21]

[15] Proposal, p 3, 117.

[16] Proposal, p 118.

[17] ElectraNet 2008, Draft Decision, p 173; Final Decision, p 79.

[18] SP AusNet 2008, Final Decision, p 116.

[19] *Powerlink Queensland Transmission Network Revenue Cap 2007-08 to 2011-12* (**Powerlink 2007**), Final Decision, p 110.

[20] Proposal, Appendix 15, p 9-11.

[21] ElectraNet 2008, Draft Decision, p 172; SP AusNet 2008, Draft Decision, p 140.

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7. SCALE FACTORS; RELATIONSHIP BETWEEN OPEX AND CAPEX

7.1 Transend has applied no scale factor to field operations and maintenance.[22] This contrasts with Powerlink and ElectraNet, which applied a scale factor of 95% to field maintenance.[23] The fact that Transend proposes a zero-based forecast for this category of opex does not mean there is no scope for economies of scale. While Transend asserts that its "bottom-up" approach to developing its field operations and maintenance profile takes account of efficiency gains,[24] no details are provided as to how this is done or the savings attributable to this process. Similarly, while Transend asserts that aspects of its capex program will have a positive influence on opex,[25] no details are provided as to how this will be done or the size of such savings in forecast opex. Without this information, it is impossible to provide informed comment on whether Transend's opex forecast is consistent with the NER.

8. EQUITY RAISING COSTS

8.1 Transend has sought $12 million over the regulatory period for equity raising costs.[26] This is comprised of:

(a) costs associated with Transend's opening RAB; and

(b) equity raising costs relating to future capex, on the basis of a cost of 7.6% of the amount of equity to be raised.

8.2 With respect to equity raising costs associated with its opening RAB, Transend states:

> *"It is important to note that the ACCC's 2003 revenue cap decision for Transend stands apart from other ACCC decisions at that time by disallowing Transend's proposed equity raising costs. In its most recent revenue cap decisions for ElectraNet and SP AusNet, the AER has accepted further clarifying advice from ACG that equity raising costs should be allowed in respect of the initial asset base. It should be noted that Transend's circumstances prior to the ACCC's 2003 revenue cap decision were identical to those of ElectraNet and SP AusNet.*
>
> *In light of these recent AER decisions, Transend's view is that it should now be treated on a comparable basis to SP AusNet and ElectraNet in relation to the recovery of equity raising costs. In particular, there is no reasonable basis for the AER continuing to disallow Transend's recovery of equity raising costs in respect of Transend's initial asset base."*

[22] Proposal, p 117.

[23] ElectraNet 2008, Draft Decision, p 175; Powerlink 2007, Draft Decision, 134.

[24] Proposal, p 121.

[25] Proposal, p 103-104.

[26] Proposal, p 124.

8.3 In December 2004, the ACCC commissioned advice on this issue from Allens Consulting Group. Based on this advice, the ACCC and AER have adopted an approach described by the AER in the following terms:

> *"allow benchmark equity raising cost when setting an initial RAB value; disallow benchmark equity raising cost when the RAB has been established; and assess the need for benchmark equity raising cost associated with capex on a case by case basis."*[27]

8.4 The proper approach to this issue is discussed in greater detail in the SP AusNet 2008 Final Decision at pages 143-145. Prior to making this decision, the AER obtained further advice from Allens Consulting Group which was, in summary:

- if the RAB has been established and locked-in, it should not be re-opened to include equity raising costs;
- if the initial RAB did include an allowance for equity raising costs, that value should remain.[28]

8.5 Having considered this advice, the AER concluded:

> *"if an asset base is locked in, the integrity of that valuation should be preserved regardless of whether or not it includes equity raising costs. If at the time of locking in a RAB it was not considered appropriate to include equity raising costs, the RAB should not be subsequently altered, even if views on the appropriateness of equity raising costs change. Revaluing one section of the RAB to account for changed views, without reopening the entire asset base to account for changed views on the other valuation of other assets, would be inconsistent. To provide certainty to service providers and end users, it is clearly preferable to maintain the integrity of the initial valuation, rather than reopening the entire RAB. Chapter 6A permits adjustment of a TNSP's RAB only in limited circumstances, which do not include changing views on the regulatory treatment of equity raising costs.*
>
> *ACG notes that whilst equity raising costs were not included in the 2002 RAB, a separate opex allowance for equity raising costs was granted in this decision. In effect, ACG argues that the inclusion of this opex allowance was analogous to including equity raising costs in the RAB, and on this basis that it would be appropriate to continue that allowance in this decision. The AER considers this a valid argument, and an appropriate application of the principles in ACG's original and updated advice to SP AusNet's specific circumstances."*[29]

[27] ElectraNet 2008, Final Decision, p 88.

[28] SP AusNet 2008, Final Decision, p 144-145.

[29] SP AusNet 2008, Final Decision, p 146.

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8.6 At the heart of Transend's argument lies the proposition that it is in the same position as ElectraNet and SP AusNet, and is therefore entitled to the same treatment with respect to the addition of equity raising costs with respect to its initial RAB. This proposition is incorrect.

8.7 Transend's 2004 opening RAB was established by the Tasmanian Government. The ACCC was bound by the *Tasmanian Electricity Code* to accept this valuation as it did not exceed DORC.[30] The basis of the jurisdictional valuation was set out in a paper prepared by the Tasmanian Government and lodged with the ACCC.[31] It was also the subject of lengthy discussion in the ACCC's Final Decision and a review by GHD. Nowhere in the Tasmanian Government's valuation of Transend's opening RAB or the ACCC's consideration of that valuation is it suggested that the valuation includes equity raising costs.

8.8 Further, the ACCC expressly rejected the submission that Transend should be permitted an allowance for equity raising costs going forward, stating that:

> *"equity raising costs should not be allowed for Transend because:*
>
> - *it is unlikely that Transend would incur equity raising costs during the regulatory period, therefore any provision will have to be notional*
> - *return on equity is a benchmark return calculated using the CAPM."*[32]

8.9 Transend's circumstances are not the same as those applicable to ElectraNet or SP AusNet. Equity raising costs were neither expressly nor implicitly included in Transend's 2004 opening RAB. To include such an allowance now would be a direct contradiction of the principle stated by the AER at page 146 of the SP AusNet decision.[33]

8.10 RTA also notes that Transend seeks a significant increase in the cost of equity assumed for the purposes of equity raising costs going forward. While recent decisions have assumed a cost of equity ranging from 2.15% to 3%,[34] Transend seeks a cost of equity of 7.6% for the reasons set out in Appendix 19 to the Proposal. This argument centres on the need to recognise both direct and indirect equity raising costs.

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[30] Transend 2004, Final Decision, p 25.

[31] "*Transend Networks Pty Ltd, Valuation of Transmission Assets*", Department of Treasury and Finance, August 2003.

[32] Transend 2004, Final Decision, p 22.

[33] see paragraph 8.5 above.

[34] ElectraNet 2008, Draft Decision, p 180; SP AusNet 2008, Final Decision, p 147; Powerlink 2007, Final Decision, p 102.

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8.11 Transend's arguments relating to efficient equity raising practices need to be placed in their proper context. This allowance is not intended to compensate Transend for its actual equity raising costs. It is a *benchmark* which must, by definition, have a degree of consistency with similar allowances made for other TNSPs in comparable circumstances. There is no basis to depart from the benchmark cost of equity raising assumed by the AER in recent transmission revenue cap decisions.

9. DEBT RAISING COSTS

9.1 Transend has sought $5.4 million over the regulatory period for debt raising costs.[35] This allowance assumes a benchmark cost of debt raising of 15.5 basis points. Again, this is based on the argument that there is a need to recognise both direct and indirect costs.[36]

9.2 RTA makes the same comment with respect to debt raising costs as it does with respect to equity raising costs. Recent decisions have assumed a debt raising cost of 8.1 to 8.5 basis points.[37]

9.3 Transend's actual debt raising costs should be low. The ACCC has reported that it is the lowest geared of the TNSPs regulated under the national regime.[38] Again, this is a benchmark allowance that must, if it is to be allowed at all, be consistent with the benchmark debt raising costs assumed for similar TNSPs in recent decisions.

<u>OPENING RAB</u>

10. EX POST REVIEW

10.1 Pursuant to cl 11.6.9 of the NER, the AER is to conduct an ex post review of the capex undertaken by Transend in the current regulatory period in accordance with the principles set out in the DRP[39] and SRP.[40] A similar review was undertaken for SP AusNet and ElectraNet.

10.2 Transend seeks to explain the prudency of its capex in the current period at pages 41 to 43 of its revenue proposal. The brevity of this submission is surprising given that:

(a) Transend expects a capex overspend of almost 25% in the current period (253.6% in the final year); and

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[35] Proposal, p 123.

[36] Proposal, Appendix 19.

[37] Powerlink 2007, Final Decision, p 95; SP AusNet 2008, Final Decision, p 149; ElectraNet 2008, Final Decision, p 179.

[38] *Transmission Network Service Providers Electricity Regulatory Report for 2005/06*, ACCC, June 2007, p 32.

[39] *Draft Statement of Principles for the Regulation of Transmission Revenues*, ACCC, 1999.

[40] *Statement of Principles for the Regulation of Transmission Revenues*, ACCC, 2004.

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(b) the ACCC expressed concerns about the size of Transend's renewals program in its 2004 revenue cap decision and emphasised the importance of Transend:

(i) applying the regulatory test or abiding by OTTER's planning requirements;

(ii) demonstrating that its renewals expenditure is economically justified; and

(iii) reporting its actual capex throughout the period.[41]

10.3 The thrust of Transend's submission appears to be that its governance process (which is summarised at pages 31 to 34) demonstrates that its investment decisions have been prudent.

10.4 It is impossible for RTA to make detailed comments with respect to the prudency of Transend's capex in the current period, as the only information published with respect to this capex program is a list of major projects on pages 42 to 43 and the list of historic capex projects (with very brief explanations) in Appendix 3. No information has been made available regarding Transend's compliance with the requirements of Chapter 5 of the NER, making it impossible to determine whether Transend has followed the ACCC's requirements to ensure it complies with the relevant requirements of the NER, including the regulatory test where appropriate.

10.5 RTA urges the AER to undertake a thorough review of Transend's past capex, with particular emphasis on:

(a) Transend's compliance with the requirements of Chapter 5 of the NER, including the timing of its capex;

(b) its management and delivery of projects; and

(c) the reasons for the anticipated 253.6% overspend in the final year of the current regulatory period.

10.6 While the TNSP's planning and governance process may be relevant to the AER's assessment of the prudency of capex, consideration of that process is not a substitute for a proper review of capex in accordance with paragraph B4 of the SRP.

10.7 Transend's renewals program deserves particular attention. In its revenue cap determination for the current regulatory period, the ACCC approved an average annual allowance for renewals of $32 million (in 2002/03 terms).[42] Transend's actual capex on

[41] Transend 2004, Final Decision, p 42, 48.

[42] Transend 2004, Final Decision, p 47.

renewals will significantly exceed this allowance.[43] At the time it approved this allowance, the ACCC emphasised that:

> *"given the size of the renewals program, Transend should be required to demonstrate that its renewal expenditures are economically justified and that there are no other, more cost effective, alternatives."*[44]

10.8 Transend has been aware, since 2003, that the size of its renewals program is a cause for concern to the regulator. It has been put on notice that the regulator requires it to demonstrate that its renewals capex is economically justified and that there are no alternatives that are more cost effective. Whether Transend has done this should be a focus of the AER's ex post review. The renewals capex that Transend will undertake in the current period should not be rolled into the RAB unless Transend is able to demonstrate that this expenditure is economically justified and cost effective.

10.9 Finally, in paragraphs 1.1 to 1.10 above, RTA has noted the provisions of the NER which require that forecast capex relates only to prescribed transmission services. In conducting its ex post review, the AER should ensure that Transend's past capex is properly allocated to prescribed transmission services and not negotiated transmission services. This is of particular relevance with respect to any capex associated with the commissioning of Basslink.

11. ROLL FORWARD OF THE RAB

11.1 Table 9.1 on page 148 of the Proposal purports to show Transend's roll forward of its RAB from 1 January 2004 to 30 June 2009. Because the completed roll forward model remains a confidential document, RTA is unable to comment at this time on whether Transend has properly applied cl S6A.2.1(c) and (f) of the NER in the determination of its opening RAB. RTA urges the AER to review this closely.

OTHER ISSUES

12. SERVICE TARGET PERFORMANCE INCENTIVE SCHEME

12.1 In its assessment of SP AusNet's revenue proposal, the AER rejected certain values for the STPIS on the basis that the rewards for exceeding certain targets were greater than the penalties for failing to meet them.[45] RTA is of the view that the same principle should apply to Transend.

12.2 Applying this principle, RTA believes the AER should reject:

[43] Proposal, p 40.

[44] Transend 2004, Final Decision, p 48.

[45] SP AusNet 2008, Final Decision, p 180.

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(a) the proposed deadband for the "Loss of supply > 1.0 system minute" sub-parameter; and

(b) the collar and cap for the "Average outage duration (transformers)" sub-parameter.

12.3 With respect to the first sub-parameter, the effect of Transend's deadband is that Transend receives a reward as soon as it betters its target of 2 events (ie. 0 or 1) but will incur no penalty unless it has 4 or more events. The deadband should be removed, such that a penalty will be attracted if Transend exceeds its target (ie. 3 or more events). SKM recommended that a deadband of 2 to 3 be included on the basis that the performance in 2007 was particularly good due to unusually dry weather conditions (thus lowering the 5 year average). RTA does not believe this constitutes a basis to depart from a 5 year average (as required under cl 3.3(g) of the STPIS) since such weather conditions may continue over the coming regulatory period.

12.4 With respect to the second sub-parameter, the collar is proportionately greater than the cap, with the effect that Transend's performance must be disproportionately worse before reaching the maximum penalty. This was recommended by SKM in order to avoid "an unrealistically negative cap value".

12.5 RTA recognises that this sub-parameter will attract a zero weighting in the coming period. However, if the AER permits Transend to include an asymmetric incentive in this decision, it will be harder to undo this outcome in future periods when performance against this parameter counts towards Transend's financial outcome under the scheme.

13. FORECAST INFLATION

13.1 RTA submits that the AER should continue to forecast inflation in accordance with the methodology used in the ElectraNet and SP AusNet decisions rather than the approach recommended by CEG in Appendix 14 to the Proposal.

13.2 Based on the forecasts in the RBA's May 2008 *Statement of Monetary Policy*,[46] this would produce an average 10 year inflation forecast of 2.75% per annum rather than the 2.54% proposed by Transend. This inflation forecast should be used instead of the forecast assumed by Transend in various components of the revenue proposal.

13.3 The problems with forecasting inflation by reference to forecast yields on Commonwealth Government Securities using the Fisher equation are now well documented. Since this issue was raised by Powerlink in 2007, the AER has undertaken a lengthy process of consultation and deliberation to develop an alternative method of forecasting inflation. This method, based on:

(a) the RBA's forecast for the first two years; and

[46] at p 68.

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(b) the mid-point of the RBA's target range for the next eight years,

is explained in the SP AusNet decision[47] and was applied to ElectraNet.[48]

13.4 The difficulties in forecasting inflation are equally well documented and have been canvassed at length by the AER in previous decisions. Basing inflation forecasts on RBA estimates over the first two years has two advantages. Firstly, it bases the forecasts on the estimates of the body which is given responsibility for managing inflation. Secondly, it has the advantage of consistency and predictability. As difficult as forecasting inflation has proven to be, the task will become more complicated (and the potential outcomes more uncertain) if a range of different methodologies are employed, or the methodology varies from time to time depending on the sample of forecasters used.

13.5 Given the extensive debate and deliberation surrounding this issue, it is now time for the AER to settle upon a consistent approach to forecasting inflation, namely, the approach used for the ElectraNet and SP AusNet decisions.

C. GENERAL ISSUES ARISING OUT OF THE NER AND THE PROCESS

14. SUPPORTING INFORMATION

14.1 The covering letter for Transend's revenue proposal dated 30 May 2008 states "*[a]t this stage we have not provided the more detailed documentation that is envisaged to be reviewed by the AER during its review process.*" This statement is a cause for concern. It is the responsibility of the regulated entity to submit the information that is needed to support the claims made in its revenue proposal.[49] While the AEMC, in promulgating Chapter 6A of the NER, did not seek to place a 'burden of proof' on TNSPs, it recognised that a TNSP would face a practical hurdle, in that if it fails to provide sufficient information to enable the AER to be satisfied as to whether the proposal meets the decision rules its proposal will be rejected.[50] While the AER should of course make reasonable enquiries as part of its review of Transend's revenue proposal, it should not be expected to rectify any defects in Transend's revenue proposal by seeking supporting information from Transend where it has not been provided.

14.2 If the AER considers that Transend has failed to provide the necessary information to support its claims in its revenue proposal, the proper response is for the AER to reject the relevant component of the revenue proposal rather than to undertake a process of

[47] SP AusNet 2008, Final Decision, p 99-106.

[48] ElectraNet 2008, Final Decision, p 68-70.

[49] *Re Telstra* [2006] ACompT [2006] ACompT 4 at [46]; *Envestra v Essential Services Commission of South Australia (No. 2)* [2007] SADC 90 at [207]-[218].

[50] *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Rule Determination*, AEMC, 16 November 2006, p 52.

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investigation to extract from Transend information that it could have provided at the outset.

14.3 As well as being inconsistent with the requirements of the NER, procedural fairness issues will arise if Transend is permitted to support its case by reference to material that is provided at a time when the review process is too far advanced to permit proper consideration and comment by those customers who will be most seriously affected by the revenue proposal. At various stages in its review of Transend's revenue proposal, RTA has been frustrated by the lack of information provided.

15. CONFIDENTIALITY

15.1 Several components of the revenue proposal are confidential and cannot be disclosed by the AER, including:

(a) the completed PTRM; and

(b) the completed roll forward model.

15.2 This makes it impossible for customers such as RTA to comment on whether Transend has calculated these amounts in accordance with the NER. For example, it is not clear from Table 9.1 on p 148 of the proposal whether Transend's opening RAB has been properly calculated in accordance with cl S6A.2.1(c) and (f) of the NER. Yet RTA is unable to see the actual calculations that would demonstrate this.

15.3 RTA can see no reason why the completed PTRM and roll forward model are confidential documents. The inputs into these models, including WACC parameters, capex, opex, tax, depreciation schedules and X factors, are all subject to public disclosure and scrutiny. Past capex is actually reported to the AER. RTA recognises that this is a requirement of the NER rather than a decision of the AER. However, there is a need for reform in this area.

16. TIMING

16.1 While the process that leads up to the making of a transmission determination is a lengthy one, the timetable for the Transend process is not designed to facilitate informed input by the customers who will ultimately bear the brunt of Transend's revenue proposal.

16.2 Transend's revenue proposal is almost 1000 pages in length. While several months are allowed for interested parties to digest and respond to this package, no guidance is offered with respect to the key issues. There is, for example, no issues paper identifying the principal areas of concern to the regulator. While the public forum might help identify some issues, it is scheduled to be held less than a week before submissions on the revenue proposal are due. The scheduling of this public forum at this time severely undermines its value to customers and other affected parties.

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16.3 It is a common (and often a sensible) practice for a TNSP to consult with the regulator during the formulation of a revenue proposal. However, we do not know whether this has occurred in the present case or, if it has, what was discussed. Again, this is a matter that could (and should) have been addressed in an issues paper.

16.4 It must be remembered that customers (even major transmission customers) are generally unable to maintain a team of staff devoted to regulatory reviews and processes. When this factor is combined with the size of Transend's revenue proposal and the lack of any guidance on key issues, the time allowed to review and comment on this revenue proposal is less than it first appears, and significantly less than the time given to Transend to prepare the revenue proposal or to the AER to consider it.