Our Ref: D07/74804

14 November 2007

Mr Chris Pattas
General Manager
Network Regulation South
Australia Energy Regulator
By email c/- aerinquiry@aer.gov.au

Dear Chris

Submission of the AER's Draft Decision on SP AusNet's Revenue Proposal

SP AusNet submitted its Revenue Proposal to the AER on 28 February 2007. The AER's Draft Decision was published on 31 August 2007, and SP AusNet submitted its revised Revenue Proposal to the AER in response to the Draft Decision on 12 October 2007. Transend Networks Pty Ltd (Transend) welcomes the opportunity to provide this written submission in response to the AER's Draft Decision and SP AusNet's revised Revenue Proposal. Transend would like to raise the following matters:

- application of the Rules requirements in relation to capital and operating expenditure forecasts;
- the AER's use of consultants in reviewing forecast capital expenditure requirements;
- contingency allowances;
- equity raising costs; and
- exclusions for the service incentive scheme.

Each of these matters is addressed in turn.

1. Code requirements in relation to capital and operating expenditure forecasts

Transend notes that clause 6A.6.6 of the National Electricity Rules (the Rules) requires that a Revenue Proposal must include the total forecast operating expenditure for the relevant regulatory control period which the TNSP considers is required in order to achieve each of the

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following (‘*the operating expenditure objectives’*):

(1) meet the expected demand for prescribed transmission services over that period;

(2) comply with all applicable regulatory obligations associated with the provision of prescribed transmission services;

(3) maintain the quality, reliability and security of supply of prescribed transmission services; and

(4) maintain the reliability, safety and security of the transmission system through the supply of prescribed transmission services.

The Rules also define carefully the role of the AER in assessing the TNSP’s forecast expenditure. In particular, clause 6A.6.6(c) states that the AER *must* accept the TNSP’s forecast operating expenditure if the AER is satisfied that the total of the forecast operating expenditure for the regulatory control period reasonably reflects the following operating expenditure criteria:

(1) the efficient costs of achieving the operating expenditure objectives;

(2) the costs that a prudent operator in the circumstances of the relevant TNSP would require to achieve the operating expenditure objectives; and

(3) a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives.

Transend notes that similarly worded provisions are set out in the Rules in relation to capital expenditure forecasts.

Transend is concerned that whilst the AER’s Draft Decision makes numerous references to the Rules requirements that the forecast operating expenditure reasonably reflects the operating expenditure criteria, in some instances it is not clear that this wording has been fully and appropriately considered by the AER.

In particular, SP AusNet’s revised Revenue Proposal appears to provide compelling information in support of its original proposal regarding corporate costs and the escalation rate for land. Similar observations also apply in relation to capital expenditure, where in some instances SP AusNet appears to have provided substantial additional information to support its original capital expenditure forecasts. Transend is concerned, therefore, that the AER’s Draft Decision has implicitly applied a more onerous test than that mandated by the Rules. It would assist all stakeholders if the AER’s Final Decision provided a more explicit and clear consideration of the Rules requirement that the forecast expenditure should *reasonably reflect* the expenditure criteria.

2. The AER’s use of consultants in respect of capital expenditure requirements

Transend notes that the AER engaged consultants PB Strategic Consulting (PB) to undertake a review of SP AusNet’s proposed forecast capital expenditure to ensure that it satisfies the requirements of clause 6A.6.7 of the Rules. PB’s review of SP AusNet’s proposed forecast capital expenditure included a detailed examination of a representative sample of proposed projects.

In its Draft Decision, the AER explains that PB's detailed review of a representative sample of SP AusNet's proposed forecast capital expenditure projects identified a number of generic issues that may affect other capital expenditure projects. These issues include the apparently aggressive timing of asset replacements, the lack of clear economic justification, and the apparent inefficient scoping of some projects. Despite the generic issues identified, PB did not recommend any further adjustments to SP AusNet's proposed forecast capital expenditure on the basis that PB had not undertaken a detailed review of projects outside the sample list.

In light of PB's comments, the AER conducted its own further review with assistance from Nuttall Consulting. As a result of this further analysis, the AER's Draft Decision proposed further reductions in SP AusNet's capital expenditure forecasts, producing a total forecast capital expenditure that is substantially below the amount recommended by PB.

Whilst Transend does not have sufficient information to comment in detail on the validity of the AER's conclusions in its Draft Decision, Transend questions the efficacy of the AER's approach. In particular, as PB identified the possibility of systematic forecasting issues, presumably PB would have been best placed to investigate and quantify the impact of these systematic errors. Instead of engaging PB to undertake this further work, the AER chose to conduct its own review with support from a different consulting company.

Stakeholders may be concerned to note that the AER's further analysis produced an overall capital expenditure forecast that is below the amount recommended by PB. Specifically, the concern is that using a combination of consultants encourages the application of inconsistent or overlapping approaches, with the concomitant risk of forecasting error. Transend notes that the consequential cost of under-estimating capital expenditure requirements is likely to be substantially greater than the costs of an equivalent over-estimation.

In Transend's view, it would be more appropriate for the AER to ensure that all its consultants are engaged to conduct a comprehensive review of expenditure requirements in accordance with the Rules requirements. This approach would provide all stakeholders with comfort that issues are addressed properly, comprehensively and consistently.

3. Contingency allowance

Transend notes that SP AusNet's cost estimates for its station rebuild/refurbishment projects includes a contingency allowance. SP AusNet's Revenue Proposal explained that:

- The contingency allowed for the station refurbishments is to cover costs that arise when this type of complex refurbishment work is undertaken.
- The cost estimate for a station refurbishment project only covers the scope of work that can be defined at the estimation stage. Naturally issues will arise as the detailed design and installation work is undertaken.

SP AusNet's proposed contingency allowance totalled $24.8 million over the regulatory period. PB recommended removing this contingency allowance on the basis that:

- SP AusNet's base unit costs (without the inclusion of a contingency allowance) represent efficient costs when benchmarked against PB's cost database.

- The generalised ‘brownfield’ factor, and the labour and materials escalations may act to double count on some of the unknowns to which the proposed contingency relates.
- The application of a contingency reduces the incentive for SP AusNet to forecast costs accurately and implement projects efficiently.
- The risk is effectively transferred to customers, who pay for the allowance regardless of whether the cost included for contingencies is realised.

The AER accepted PB’s recommendation to remove SP AusNet’s proposed contingency allowance, noting that SP AusNet had included a number of other risk mitigation allowances in its forecast capital expenditure proposal. These include the ‘brownfield factor’ in all cost estimates involving work at a brownfield site, a suite of ‘response capability’ projects catered to unforeseen events, and real labour and materials cost escalations. The AER argued that the combined effect of these allowances and the proposed contingency allowance for station rebuild/refurbishment projects potentially double-counts the risks intended to be captured by the proposed contingency allowance, and overestimates the costs likely to be incurred.

The AER also commented that SP AusNet had not presented any strong evidence justifying the need or quantum of its proposed contingency allowances for each individual station rebuild project.

Transend understands and shares the AER’s concerns that risks should not be double-counted between different ‘risk factors’. Transend also notes that SP AusNet’s revised Revenue Proposal contains further information in relation to the contingency allowance, which appears to demonstrate that the proposed allowance is warranted. In particular, Transend notes that SP AusNet revisited the risk factors in their capital works program and engaged external consultant Evans & Peck to assess the contingency allowance. This analysis appears to demonstrate that the proposed allowance is warranted.

Transend cannot comment in detail on the appropriateness of the contingency allowance requested by SP AusNet. However, as a matter of business practice, Transend notes that it is appropriate to include contingency amounts in capital expenditure forecasts, especially when forecasts are produced for relatively long time periods (5 years or more). As a practical matter, final project conditions and planning costs cannot be known with a high degree of confidence in advance of project commencement. Typically, any project could be exposed to cost escalation as a result of planning issues or site-specific construction issues. The cost impact of these risk factors is asymmetric and, therefore, it is appropriate to address the cost forecasting risk, including through acceptance of risk factor allowances or contingency allowances.

In light of these comments, Transend encourages the AER and its consultants to take a more pragmatic approach to assessing contingency allowances in capital expenditure forecasts.

4. Equity raising costs

Transend notes with interest SP AusNet’s comments in its revised Revenue Proposal that the earlier Allen Consulting Group (ACG) report for the ACCC on equity raising costs may have been misinterpreted by the AER. In particular, SP AusNet comments that the following matters are relevant:

- Firstly, equity raising costs should, ideally, either be allowed for in the RAV or as a separate operating cost allowance.

- Secondly, if an initial RAV has been established prior to the first regulatory review it is reasonable to conclude that equity raising costs have been included in the RAV. In this instance, no further allowance for equity raising costs should be provided.

- Thirdly, if an initial RAV has not been established and it is established in a manner that does not provide for an equity cost allowance, then it would be reasonable to provide an equity raising cost allowance as an operating expenditure.

- Fourthly, and most importantly, in the latter instance it would be reasonable for the regulator to continue to provide an on-going allowance for equity raising costs in future revenue reviews, even though a RAV might have been established at the commencement of those later reviews.

In relation to the above matters, SP AusNet believes that the ACG report to the ACCC may not have been sufficiently clear and therefore the report has been misinterpreted by the AER. Importantly, SP AusNet has asked ACG to clarify its views on this matter, and a letter from ACG has been attached to SP AusNet's revised Revenue Proposal.

Transend would like to make two observations in relation to equity raising costs:

(1) SP AusNet's comments relate to the equity raising costs in relation to the initial regulatory asset base. The original ACG report for the ACCC explained that in addition to this issue, equity raising costs may be appropriate for new capital expenditure where this cannot be financed from retained earnings. It is important that this rationale for equity raising costs is not ignored, even though it may not apply in SP AusNet's circumstances.

(2) It is important that the AER adopts a consistent approach to equity raising costs across all TNSPs. Transend has previously noted that the ACCC had adopted an inconsistent approach, in part because it was unsure of the appropriate regulatory treatment of this issue. In this regard, Transend's view is that the AER should not simply 'lock-in' the ACCC's earlier approach to equity raising costs. Transend notes that the inclusion by SP AusNet of further advice from ACG is a very constructive step forward, which should assist the AER in developing a consistent and appropriate approach to the treatment of equity raising costs.

5. Exclusions for service incentive scheme

An important aspect of the service incentive scheme is the treatment of certain events as exclusions. Transend notes that SP AusNet proposed a third party outages exclusion definition as follows:

- Exclude from 'circuit unavailability' any outages shown to be caused by a fault, outage request or other event on a '3rd party system' e.g. intertrip signal, generator outage, customer installation (TNSP to provide lists).

- Any outage requested by a 3rd party for construction or demolition activities on land over which the TNSP has an easement.

Transend notes that SP AusNet's revised Revenue Proposal explains that:

- All TNSPs should be encouraged to align where possible outages on their own equipment with outages on customer equipment. For example, where a Generator takes plant offline for maintenance a TNSP should be encouraged to complete its own maintenance on assets connected to that plant at the same time so that additional outages that disconnect the generating plant when it is actually available are unnecessary. In these cases, exemptions would actually strengthen the incentives in service standards regime.

- The relevant issue is that the magnitude of the associated outage is completely outside the control of the TNSP.

Whilst Transend would like to reserve its position on exclusions for its forthcoming Revenue Proposal, the company supports the arguments presented by SP AusNet in its revised Revenue Proposal. Transend encourages the AER to give careful consideration to these matters in its Final Decision.

Transend would be pleased to discuss any aspects of this submission with you or your staff.

Yours sincerely

[by email]

Bess Clark
Executive Manager Revenue Regulation