TRANSEND

Our Ref: D13/50899

Your Ref:

1 November 2013

Mr Warwick Anderson
General Manager
Network Regulation
Australian Energy Regulator
GPO Box 3131
Canberra ACT

Email: SPAusNetTransmission.2014@aer.gov.au

Dear Warwick,

Submission in relation to SP AusNet's draft decision and revised revenue proposal 2014-17

Transend welcomes this opportunity to provide this submission in response to SP AusNet's draft decision and revised revenue proposal for the 2014-17 regulatory control period.

Transend notes that the AER's draft decision raises a number of important company-specific matters, which are best addressed bilaterally by the AER and SP AusNet. Rather than discussing these matters in this submission, Transend's particular interest relates to issues of regulatory precedent and approach that arise from the draft decision. With this focus in mind, our submission addresses the following issues:

- The AER's characterisation of EBSS payments as a "backup" if the AER's operating expenditure allowance is inadequate.
- Prudency reductions in relation to forecast capital expenditure.
- The treatment of strategic IT capital expenditure.
- Cost pass through arrangements, particularly in relation to above insurance cap events.

Each of these matters is addressed in turn.

Transend Networks Pty Ltd
ABN 57 082 586 892

PO Box 606 MOONAH TAS 7009
Phone 1300 361 811
Fax (03) 6274 3872
www.transend.com.au

EBSS payment as a backup in case of regulatory error
On page 118 of the draft decision, the AER states:

> "The revealed costs approach provides a reliable means of determining the opex forecast, and the EBSS operates as something of a backup. We are required to make a best estimate of an opex forecast that meets the opex criteria. While that means that a judgment needs to be made as to whether any efficiency in the past period was one-off or lasting, an error in this assessment should not have adverse results for SP AusNet."

The AER's suggestion that the EBSS provides a "backup" that may compensate for regulatory error is inconsistent with the requirements of the National Electricity Law (NEL) and National Electricity Rules (NER).

Specifically, section 16(2) of the NEL provides that the AER must take into account the revenue and pricing principles when exercising a discretion in making a transmission determination. Section 7A of the NEL sets out the revenue and pricing principles, which (among other things) require regulated network service providers to be provided with a reasonable opportunity to recover at least the efficient costs incurred in providing regulated services.

Clause 6A.6.5(a) of the NER defines the EBSS as an incentive scheme that provides for a fair sharing between TNSPs and Transmission Network Users of the efficiency gains derived from the operating expenditure of TNSPs. Clause 6A.6.5(b) requires the EBSS to provide TNSPs with a continuous incentive to reduce operating expenditure. It is not possible to construe any of the provisions in clause 6A.5 of the NEL as supporting the characterisation of the EBSS as a "backup" that may compensate for regulatory error.

Clause 6A.6.6(e) sets out the factors that the AER must have regard to in assessing a TNSP's operating expenditure forecast. Paragraph (8) of that clause requires the AER to consider whether the operating expenditure forecast is consistent with any incentive scheme or schemes that apply under clauses 6A.6.5, 6A.7.4 or 6A.7.5. These provisions do not contemplate the characterisation of the EBSS as a backup to compensate for regulatory error.

Transend's concern in relation to this issue is that the AER's approach will weaken the incentive properties of the regulatory regime, and may also result in an inadequate operating expenditure allowance. Both of these outcomes are contrary to the long-term interests of consumers, and therefore inconsistent with the National Electricity Objective.

Prudency reductions in capital expenditure
The AER's draft decision concluded that SP AusNet's capital expenditure forecasts should be reduced by approximately $26 million to reflect a "prudency adjustment". While the prudency adjustment is applied to forecast capital expenditure for 2014-17, it is derived from an analysis of forecast and actual expenditure for the previous regulatory period.

In particular, the AER's consultant, EMCa, explained that SP AusNet spent approximately 12 per cent less than proposed in the previous regulatory period and, therefore, the same efficiencies can also be expected in the forthcoming period. The AER essentially accepted EMCa's analysis and conclusions.

Transend notes that SP AusNet's revised revenue proposal identified two important differences between the previous and forthcoming regulatory periods, which SP AusNet consider undermine EMCa's conclusions. These differences are

- The capital expenditure forecast is for a period of three years, and is much more certain than the 2007 forecast which spanned six years.

- Developments and improvements have been achieved in asset management and forecasting capital expenditure since 2007, such that the two forecasts are not comparable.

SP AusNet argues that the AER's draft decision implicitly assumes that the circumstances that led to the level of underspend in capital expenditure in the previous regulatory period will also apply in the future. It is evident from the above differences identified by SP AusNet that this assumption is incorrect. As a consequence, the prudency adjustment applied by the AER is not reasonable.

More generally, as a matter of regulatory principle, Transend considers it important that capital expenditure forecasts are judged on their merits and not subject to "rules of thumb" or broad-brush adjustments. As TNSPs deliver cost efficiencies, and improve their estimation and governance processes over time, it is not appropriate to assume that historic performance will simply be repeated in the future. Instead, TNSPs should be expected to drive efficiency gains and incorporate these efficiencies in the cost estimation process as well as continually improve their forecasting methodology. If evidence can be provided to demonstrate these improvements, then the AER should accept the forecasts as satisfying the NER requirements - even if actual capital expenditure in the previous period was less than forecast.

Strategic IT capital expenditure

The AER's draft decision appears to have disallowed approximately $17 million of IT capital expenditure on the grounds that the expenditure is 'strategic' and not sufficiently justified by operating expenditure savings. In response to the draft decision, SP AusNet argues that:

- The implicit assumption that the merits of forecast IT capital expenditure should be assessed solely on the basis of expected reductions in controllable operating expenditure is flawed.

- The quantification and analysis of forecast 'strategic' investment is incorrect and unreliable.

- The benchmarking results, which underpin EMCa's recommendations and the draft decision, are inaccurate and unreliable.

In terms of good regulatory practice, the key question from Transend's perspective is whether it is reasonable to assume that 'strategic' IT capital expenditure should be self-financing by delivering operating expenditure efficiencies. Transend notes that the NER establish *capital expenditure criteria* and *capital expenditure objectives* for determining whether the company's forecasts should be accepted by the AER. The relevant objectives are that capital expenditure should:

(1) meet or manage the expected demand for prescribed transmission services;

(2) comply with all applicable regulatory obligations or requirements 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.

These objectives do not require capital expenditure to be self-financing. In fact, if this requirement were imposed on all capital expenditure forecasts it is highly unlikely that the important objectives set out in the NER would be satisfied.

Transend notes that 'strategic' IT capital expenditure may well be focused on managing network risk, including the increased risk of cyber-attacks, rather than being strategic in the sense of delivering operating expenditure efficiencies. More generally, commercial businesses do not justify IT capital expenditure solely on the basis that the expenditure will deliver operating expenditure savings. Often, capital expenditure in IT is justified in order to maintain the security and integrity of systems that are core to the operation of the business or improve outcomes for customers..

In summary, it appears a narrow and unduly challenging test in relation to IT capital expenditure has been applied, which cannot readily be justified with reference to the NER requirements or normal commercial practice.

Cost pass through arrangements

As noted by the AER in the draft decision, the pass through mechanism of the NER recognises that a TNSP can be exposed to risks beyond its control, which may have a material impact on its costs. Accordingly, a cost pass through enables a business to recover (or pass through) the costs of unpredictable, high cost events that are not built into the transmission determination.

SP AusNet proposed three nominated cost pass through events, being: a natural disaster event; a terrorism event; and a liability above insurance cap event.

Transend supports the AER's draft decision in relation to the definitions of natural disaster event and terrorism event, which we note have also been accepted by SP AusNet in its revised revenue proposal.

It is noted that SP AusNet's revised "nominated liability above insurance cap" event does not adopt the definition of insurance cap event set out in the draft decision. Instead, SP AusNet proposed a minor change to this definition to enable this pass through event to cover situations where SP AusNet does not receive an insurance payment directly from its insurers, but still receives the benefit of an insurance claim. Transend considers that SP AusNet's revised proposal in relation to this matter is consistent with the substance and intent of the draft decision, and therefore we support it.

The AER has previously signalled that it may revisit its approach to pass-throughs and self-insurance. Transend encourages the AER to undertake a full consultation process before any change to the current approach is introduced.

As noted at the outset, Transend's interest in responding to the AER's draft decision for SP AusNet is focused on matters that raise issues of regulatory precedent and approach. We trust that the AER will carefully consider the matters raised in this letter in the course of making its final decision.

Yours Sincerely

BClark

Bess Clark
Executive Manager Corporate Strategy and Compliance