

Submission by:

Energy Users Association of Australia (EUAA)

## **ENERGYAUSTRALIA REVISED TRANSMISSION CAPEX PROGRAMME**

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## **FOREWORD**

The Energy Users Association of Australia (EUAA) appreciates the opportunity to provide comments for consideration on EnergyAustralia's revised transmission revenue cap application in response to the ACCC's proposed regulatory framework.

As you may be aware the EUAA is a non-profit organisation focused entirely on energy issues on behalf of large business end users of electricity and/or gas. The EUAA currently has approximately 80 members. Membership ranges across a number of sectors, including mining, manufacturing, construction, commercial property and service sector. Many of the EUAA's members operate across States.

Hence, this submission represents the views of large consumers of EnergyAustralia's transmission services. Our submission addresses the main issues of concern to our members and seeks to ensure that these issues are captured in the ACCC's consultation and decision-making processes.

The submission has been assisted by funding provided by the National Electricity Consumer Advocacy Panel and technical input from McLennan Magasanik Associates Pty Ltd (MMA). This support is gratefully acknowledged.

It should be noted, however, that the views expressed herein are solely those of the EUAA. The EUAA will also be making a separate submission on the Transgrid revised CAPEX proposal to the ACCC.

Any enquiries regarding this submission should be addressed to Mr. Con Hristodoulidis, Director, Policy and Regulation of the EUAA on telephone (03) 9898 3900 or email [con.hristodoulidis@euaa.com.au](mailto:con.hristodoulidis@euaa.com.au).

## 1 INTRODUCTION

The Energy Users Association of Australia (EUAA), appreciate the opportunity to provide comments for consideration on EnergyAustralia's transmission capital investment expenditure application to the Australian Competition and Consumer Commission (ACCC). This submission addresses the main issues of concern to our members and seeks to ensure that these issues are captured in the ACCC's consultation process. It is our view that the application has significant deficiencies and cannot be approved without significant amendments. These deficiencies include:

- the potential incentive for the TNSPs to inflate the likely cost of capex given that in both capped and excluded projects cases, the TNSPs will retain the returns to any underspend for the 5 year period,
- the revised claim represents a more than doubling of capital expenditure when compared with its original application when the original was only prepared some months earlier,
- a 75% increase in replacement capex with no corresponding reduction in opex when compared with its original application,
- a failure to adequately justify the reasons for the massive increase in capex,
- a failure to outline the impact of the revised capex will have on tariff classes,
- an unquantified amount for customer connections when such an amount should be provided for in the ex-ante allowance,
- a failure to specify how demand side management has been encouraged to reduce system peak load, and
- a failure to include an assessment on the impact on customers such a massive increase in capex will have on customer bills.

## **2 THE EX-ANTE APPROVAL REGIME**

EnergyAustralia (and TransGrid) have submitted their revised transmission capital investment programme in accordance with the ACCC's Draft Decision based on the ex-ante capex regime found in the Statement of Regulatory Principles (SRP). The change from an ex-post to an ex-ante capital incentive regime is aimed at providing an incentive to ensure efficiency in the transmission network service provider's (TNSP) capital expenditure. While customers welcome the ACCC's desire to provide incentives for efficiency, we are unsure of how these incentives will work and thus are withholding our total support until we see its impact. Of concern at this stage is the evidence we see that there is some attempt at gaming of the new arrangements.

The features of the new regime include:

- An ex-ante allowance that covers most or all expected investments during the regulatory period.
- An excluded projects provision that covers very large and uncertain investments.
- Projects under the ex-ante allowance would be specified up front, but the TNSP would have discretion as to what projects it constructs.
- TNSPs will be required to provide quantified analysis of the relationship between any cost drivers (such as growth in peak demand) and the resulting investment requirement.
- The proposals would also need to establish how the relevant parameters would be measured and audited.
- A project is excluded from the main ex ante capex allowance if the expected error presented by the inclusion of that project in the main allowance—quantified in terms of the revenue required to cover depreciation and the return on investment in that project—is equal to more than 10 per cent of the revenue required to cover depreciation and return on investment of all projects included in the calculation of the main ex ante capex allowance.
- TNSPs can apply to the ACCC for specific projects to be excluded from the ex ante allowance, even where this value threshold is not satisfied. It will be at the ACCC's discretion as to whether these projects will be considered as excluded projects.

- Projects excluded from the ex ante capex allowance must be linked to unique investment drivers—such as a major point load or expected power station—rather than to general investment drivers (such as expectations of load growth within a region).
- TNSPs will be compensated (subject to the event meeting the threshold) against cost increases resulting from events that lead in cost increases. There are no provisions to reduce the ex-ante cap should forecast events not occur.

Of some concern to customers, in the new ex-ante regime, is the potential incentive for the TNSPs to inflate the likely cost of capex given that in both capped and excluded projects cases, the TNSPs will retain the returns to any underspend for the 5 year period. While the draft SoRP had indicated that TNSPs will not be compensated for any overspend above the ex-ante cap, the final decision provides that the written down value of the actual investment in that period that complies with the code will be rolled into the RAB. This opens the way for an ex-post review of investments as well as allows capex spend above the cap to be included in the RAB moving forward.

The ACCC should consider allowing the sharing of any gains from capex underspend in the following regulatory period with customers partially compensating the TNSPs for prudent overspending on projects that were not envisaged during the regulatory review. This may reduce the incentive to the TNSPs to overstate expected capex spend while still providing a level of incentive to operate efficiently.

With the transition to this new arrangement, customers would urge the ACCC to keep a close eye on how the arrangements are actually put into practice by the TNSPs. It is our contention that EnergyAustralia has engaged in grossly inflating their ex-ante capex requirements to obtain a high allowance given these arrangements. This comment is made on the basis of the significant increase in capex when compared with the past as well as when compared with the original application. This is expanded on in the following sections of this submission.

### 3 PROPOSED CAPEX

#### 3.1 ENERGYAUSTRALIA'S REVISED PROPOSAL

EnergyAustralia has proposed a total capex spend of \$255.7m plus an (unquantifiable) amount to cover the customer connections (depending on customer requirements) and the impact of variations to the scope of water treatment for the Haymarket cable tunnel. Of this total some \$146m are covered by the ex-ante cap and approximately \$109.7m (plus customer connections and the Haymarket Tunnel variations) are regarded as excluded projects.

The projects covered under the proposed ex-ante cap include:

- \$48.0m of augmentations
- \$93.9m for asset replacements
- \$4.1m for compliance

This revised claim represents a substantial increase in capex over and above the original application. In its original application of September 2003, EnergyAustralia states that there will be a trade off between replacement capital and operating expenses. In its original application, replacement capital amounted to about \$55m (almost the equivalent amount of total capex allowed under the previous regulatory period). Operating expenses, however, have not fallen from the previous regulatory period but were, in fact, forecast to increase by some 65%. In the revised application, however, a further increase in replacement capex to \$94m is accompanied by the statement that:

“the total increase in replacement spending over five years compared to our initial claim (September 2003) is \$41m. EnergyAustralia believes this to be a relatively small increase in the replacement program that will have a negligible impact on opex in the 2004-2009 period due to the types of equipment being replaced.” (pg 79)<sup>1</sup>

EnergyAustralia seems to want to have its cake and eat it too! The increase in replacement is not a “relatively small increase”; it is a 75% increase, and as such cannot be said to have a “negligible impact on opex”. Customers must ask why it is necessary to replace assets if by doing so it would not lead to any operational savings or efficiency. Companies in the real economy will not be able to make such a claim to their board of directors. In the real economy, capital replacement

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<sup>1</sup> EnergyAustralia, *EnergyAustralia's Submission to the Australian Competition and Consumer Commission, Transmission Revenue Determination 2004-2009*, September 2003

investments will only be approved if it leads to lower operating and maintenance costs. Spending \$41m to replace existing assets, without any corresponding savings in opex, will simply not be permitted to occur in companies operating in the real economy. As the economic regulator, it is ACCC's role to mimic the forces of competition on monopoly network service providers. The ACCC therefore needs to require EnergyAustralia to reconcile the two statements made otherwise apply significant reductions to either the replacement capex or opex or both. Failure to do so would mean that the ACCC is countenancing a significant reduction in the operating efficiency of EnergyAustralia.

EnergyAustralia has also requested an unquantified amount to cover the customer connections. This puts customer connections into the excluded category. We note that in the ACCC's decision, excluded projects "must be linked to unique investment drivers—such as a major point load or expected power station—rather than to general investment drivers". General customer connections cannot be considered a "unique investment driver" and as such should be included in the ex-ante allowance. We also question why EnergyAustralia is unable to forecast customer connections when this is routinely done in its demand forecasts. EnergyAustralia claims to be customer focused yet is unable to provide a forecast of customer numbers.

With peak demand only occurring for a very short period of time (usually only during the hottest summer days), capital investments in network assets are a very inefficient means of meeting peak demand growth. The costs incurred in investing in capacity to meet such peak demand would have to be covered during non-peak periods when such additional capacity is largely unnecessary. Peak demand growth would more efficiently be met by demand management and embedded generation where customers would be paid to reduce their demand during times of system stress. The total cost of such measures would inevitably be lower than the cost of augmenting the system to meet the limited duration during which peak demand occurs. The impact of considering only network solutions is borne disproportionately by flat load customers that do not contribute to the peak demand problem. These customers would still be faced with significant increase in cost of supply while obtaining little benefit from the additional investments. With demand side solutions, such customers may at least have the opportunity of obtaining a benefit if they are paid to shed load during times of system peak demand.

In NSW, IPART has made a determination that promotes demand management in the state. EnergyAustralia, as a distributor is subject to that determination. While EnergyAustralia has suggested that it encourages demand management and embedded generation responses, its transmission application includes little information on how it plans to implement these programs. We are concerned that the incentives transmission network service providers face continues to



discourage demand side response while promoting network solutions to managing peak demand growth. TNSPs are rewarded based on the value of their assets. This provides an incentive to increase their asset base. Demand management solutions detract from this objective as it reduces the need to expand the asset base. Regulatory incentives must be realigned to promote demand management solutions. TNSPs should be required to provide evidence of the demand management solutions that they have considered and the attempts made to obtain demand side responses.

In Section 1.1.1 of its submission, EnergyAustralia stated that it believes that one of the criteria for changing the capital investment framework should be the “and the flexibility of allowing a business to ... choose the most efficient projects.” We are concerned that this reflects the approach that EnergyAustralia has taken to its capital investments. While an investment may be the “most efficient project”, it may not necessarily be the most efficient at meeting customer requirements if demand management is not considered a project that EnergyAustralia can undertake. A more appropriate criterion would be to determine the solution that would most benefit the customer whether the solution is network based or otherwise.

Based on EnergyAustralia’s revised application and the ACCC’s draft decision, EnergyAustralia is forecasting a total capex spend, over the next regulatory period, of over 40% of its 2004/05 RAB. Surely this is excessive given the long life nature of these assets.

It is also disappointing that when customers are expected to pay for these massive increases in capex that EnergyAustralia has chosen not to include a tariff impact assessment in its submission. Providing a tariff impact assessment would provide some transparency as to how the application would affect customers’ bills. The ACCC should require that such applications provide an analysis on how different types of customers would be affected by the application.

### **3.2 PB ASSOCIATES REPORT**

PB Associates reports<sup>2</sup> that EnergyAustralia’s actual capital spend during the previous regulatory period amounts to some \$132m. After adjusting for inflation, this amounts to about \$148m in 2004 dollar terms. We note that in its previous decision on EnergyAustralia’s transmission capex in January 2000, the ACCC only approved \$56.7m (or approximately \$60m in 2004 terms). We question the appropriateness and reasonableness of the claimed actual capex spend given that it is more than double that \$60m approved by the ACCC in 2000. We also question the size of capex (over \$255m) in the current application which is almost

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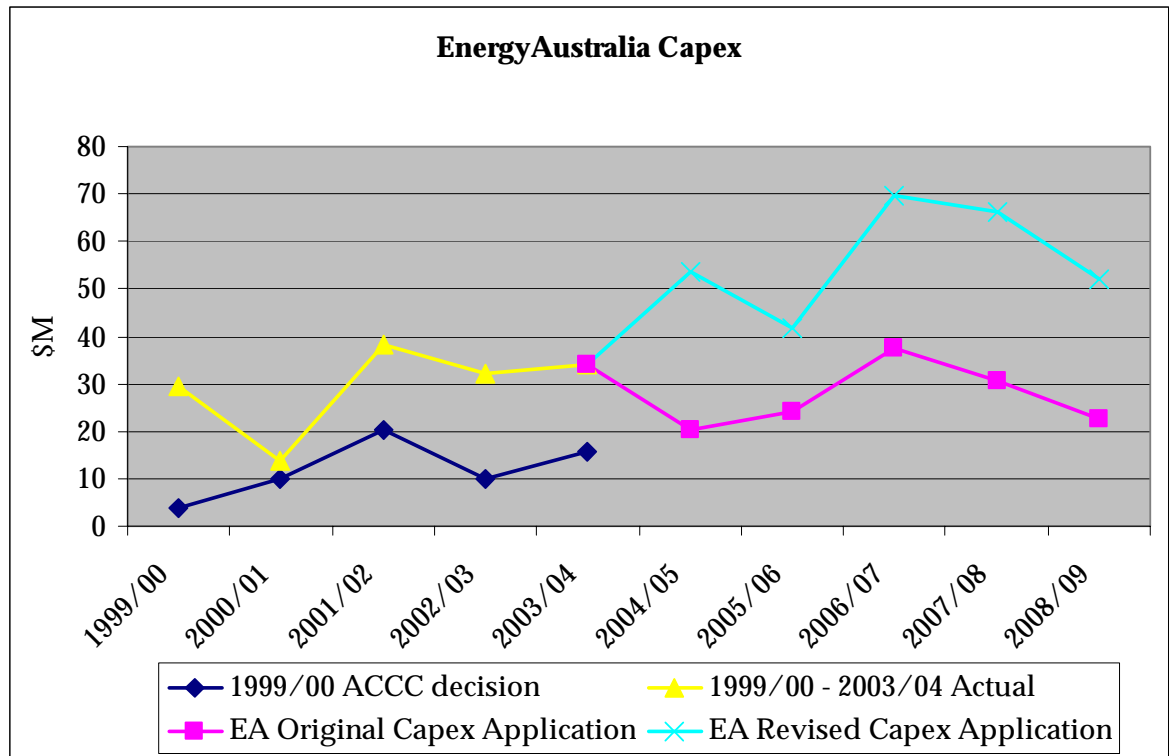
<sup>2</sup> PB Associates, Energy Australia’s Forward (Transmission) Capital Expenditure Requirements, December 2004

double the \$132m which EnergyAustralia claimed to have spent in the previous period. Surely a capex programme that increases by some 470% over that envisaged just five years ago must be seen to be excessive. The magnitude of the increase (in real terms) can be seen in Figure 1.

EnergyAustralia has offered no explanation as to what has driven this huge increase in capex. Surely forecast demand has not grown by such a substantial amount in just six months. Customers would expect to be given the reasons why this increase has occurred and the ACCC should require EnergyAustralia to explain.

Figure 1 shows the history of EnergyAustralia's capex spend. Except for 2000/01 when EnergyAustralia's actual capex spend matched the ACCC's approved capex from the 1999 regulatory decision, EnergyAustralia has consistently overspent on capex. In the first year of the previous regulatory period, EnergyAustralia in fact overspent by about 640%! How could EnergyAustralia be so wrong when it should have had a fairly good understanding of its capex spend just one year ahead? In the final three years, the overspend averaged about 150% pa. What is the value of forecasts when the magnitude of differences between forecast and actuals is so great?

Comparing the current capex forecasts with that provided with the original submission shows that within a six month period, EnergyAustralia has more than doubled their capex forecast. In every year of the forecast period, expected capex spend has increased by between 73% to 165% from that projected just a few months ago prior to the change from ex-post to ex-ante capex approval. This step increase strongly suggests that EnergyAustralia may be engaging in trying to game the ex-ante regime by submitting a high ambit claim to ensure that they will not exceed their capex cap.

**Figure 1 EnergyAustralia Capital Expenditure**

Of even greater concern to customers is the forecast replacement expenditure. Based on figures provided by PB Associates, it is clear that EnergyAustralia is forecasting to replace existing assets at a substantially higher rate than that applied in the previous regulatory period. This can be seen in Figure 2. We question the need for such an increase. Has EnergyAustralia underspent on replacement capital in the previous period and is now trying to catch up with its capital investment schedule? Or is the age profile of EnergyAustralia's asset so lumpy that over the next regulatory period, some 25% of its assets need replacement (based on the RAB of \$628m in the ACCC's draft decision)? The third possibility is that, as alluded to by PB Associates in its report to the ACCC, EnergyAustralia is in fact replacing assets before the end of its useful life and in doing so, earning increased revenues at the expense of customers? We urge the ACCC to critically assess the reasonableness of this claim.

Figure 2 also shows the huge increase in expected replacement capex spend of the revised submission when compared to the original submission. Over the regulatory period, the revised replacement capex averages some 130% more than that provided just a few months ago. In fact the biggest discrepancy in forecast occurs for the current year when the revised forecast is 363% of the original forecast.

Given the large increases in capex forecast especially in replacement expenditure, customers must question if EnergyAustralia is not engaging in an ambit claim to

eliminate any risk of overspending the cap given that they will retain all the benefits by underspending the cap during the current period.

**Figure 2 EnergyAustralia Replacement Expenditure**

