TransGrid Application for Revenue Cap – ACCC Draft Decision

ACCC Forum
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The issues

- Information disclosure
- The starting asset value
- The valuation of historic capex
- The WACC
- The valuation of future capex
- The allowance for opex
- Service standards

Information disclosure

- In the course of its three submissions, EMRF has consistently highlighted that TG has failed to provide sufficient justification of its claims.
- Based on the information provided, GHD was unable to recommend past or future capex levels
- The ACCC draft decision provides some of the missing information
- The ACCC has been unable to be satisfied about future capex claims, supporting our view on this issue
- Despite this the ACCC has not provided any disciplinary action on TG for not providing adequate information and has rushed through a draft decision based on insufficient data, providing TG a first year over-recovery in revenue, at the expense of consumers

The starting asset value

- At the last review EMRF pointed out that the valuation of easements was too high
- The ACCC advised then that they were constrained by the jurisdictional valuation
- But there has been no attempt to fix what is an obvious problem
- Other than the recent Transend decision (again constrained by the jurisdiction), the valuation for easements has essentially been on a recorded cost basis
- Why persist with a DORC valuation for TransGrid easements?
- This provides a gift of about $20m pa from electricity users to TransGrid shareholders

The historic capex to be included in the RAB

- GHD was unable to recommend a level of past capex
- In its responses to the application and the consultant report, the EMRF consistently commented that TG had not provided adequate documentation to prove all its past capex is prudent
- It is welcome that the ACCC draft decision supports this view and has disallowed significant amounts of historic capex
- It is disappointing that after all the discussions and debate about investments needing to be prudent, that TG could not provide an adequate written history demonstrating all its capex was and remains prudent

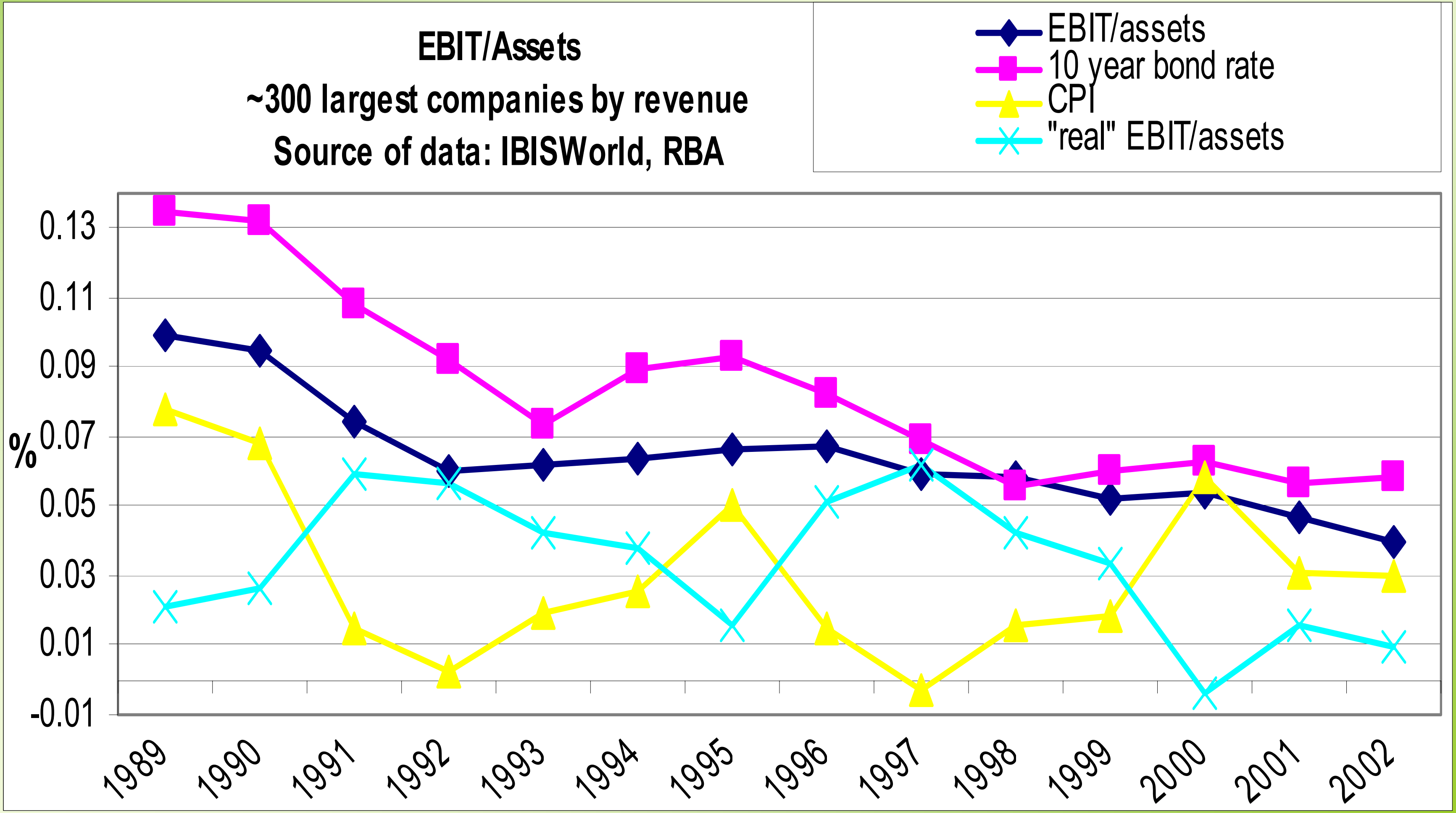
Future capex

- **The approach of TG to its past capex does not give confidence for its documentation for its future capex**
- **The ACCC is considering an ex-ante approval process for future capex, which gives greater freedom to TG.**
- **Capex must remain prudent and the TNSP must remain accountable**
- **Before EMRF will give its support to any greater freedoms for capex, the systems for proving capex is prudent *<u>and remains prudent</u>* throughout the investment duration, must be tested**
- **It is quite clear that the systems currently used by TG are inadequate**

The WACC

- **Despite the work by consumers the ACCC persists in awarding WACCs based on MRP and equity beta which are seen as too high**
- **The EMRF submitted work which is intended to provide a tool to benchmark the WACC awarded**
- **The ACCC has awarded TG a WACC which provides TG with an EBIT/RAB averaging ~11% for the period** (see DD appendix 4)
- **This is despite EBIT/assets for businesses in the competitive environment of usually less than 10% and averaging ~7% for the past ten years**

The WACC



EBIT/Assets
~300 largest companies by revenue
Source of data: IBISWorld, RBA
EBIT/assets
10 year bond rate
CPI
"real" EBIT/assets
%
0.13
0.11
0.09
0.07
0.05
0.03
0.01
-0.01
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Opex

- The ACCC has recognised that the claimed opex was too high, and its detailed evaluation supports this view
- Further it has accepted the EMRF contention that there is a disconnect between asset value and opex, that most of the capex should reduce opex
- The only capex that might lead to an increase in opex, is an increase in physical assets eg a new line. Even the increase in size of an existing asset should not increase opex
- The EMRF supports the approach of not using the last year opex as a starting point, but rather than using the 2003 opex it would recommend an average of the five years of opex be used.
- The inclusion of the 2% efficiency adjustment is welcomed but it is noted that this is a conservative figure, and benchmarking indicates that 5% is an acceptable target

Service standards

- It is accepted that TG has achieved a high level of performance in its service standards
- But existing standards have been earned from investment in the past (capex and opex), supported by consumers
- To earn an incentive requires a new target, it shouldn’t come form just maintaining current performance
- EMRF supports the ACCC approach of increasing the target levels to earn a bonus

Summary

- The EMRF is concerned that there is no penalty on TG for having failed to provide adequate information
- The previous over valuation of easements should have been rectified
- Benchmarking of the WACC shows the value awarded is too high
- The discounting of historic capes is supported
- TG must be required to have in place an auditable method for assessing prudency of capex. This method should follow the principles of quality assurance
- The ACCC approach to opex is supported although it is possibility set still too high, and should have been based on the average of the past five years
- The approach to service standards is supported