24 October 2003

Mr Sebastian Roberts
General Manager
Electricity Group Regulatory Affairs Division
Australian Competition and Consumer Commission
PO Box 1199
DICKSON ACT 2602

electricity.group@accc.gov.au

Dear Mr Roberts,

Transend Networks' Revenue Cap Application – Hydro Tasmania's Response to the ACCC Draft Decision

Please find enclosed our response to the ACCC draft decision in relation to Transend's Revenue Cap Application which expands on our presentation at the public forum in Hobart on 17th October.

Please contact me on 03 6230 5485 if there are any queries in relation to the submission.

Thank you, once again, for providing Hydro Tasmania with the opportunity to provide this submission.

Yours sincerely,

[Electronic Version]
Greg Jones
Manager Product Delivery

CC: Sabesh Shivasabesan, ACCC, sabesh.shivasabesan@accc.gov.au

Transend Networks' Revenue Cap Application
Australian Competition and Consumer Commission's
Draft Decision

Hydro Tasmania Submission

October 2003

1 Introduction

This document is Hydro Tasmania's Submission on the Australian Competition and Consumer Commission's ("the Commission") Draft Decision as part of the determination of Transend Networks' Revenue Cap Application ("the Application").

As the Commission is aware, the success of Hydro Tasmania's business is heavily reliant on the Tasmanian transmission system. Our submissions on the Application have reflected our recognition of the need to balance the requirements of providing effective transmission services whilst minimising the price shock on network customers (including Hydro Tasmania).

This Submission expands on Hydro Tasmania's presentation at the Public Forum held in Hobart on the 17th October ("Public Forum").

2 Revenue cap building blocks

The Commission's Draft Decision has examined the Application in respect of the traditional revenue cap building blocks, namely:

- Operating expenditure ("opex");
- Capital expenditure ("capex");
- Weighted Average Cost of Capital ("WACC");
- Regulatory Asset Base; and
- Depreciation.

We note the Commission's position in respect of the Regulatory Asset Base, and the adoption of its normal approach to the calculation of WACC. In particular, Hydro Tasmania endorses the approach taken to WACC in the Draft Decision. Hydro Tasmania will comment no further on either of these building blocks in this Submission.

Hydro Tasmania commends the Commission for its detailed consideration of both opex and capex, and its review and subsequent endorsement of the GHD report. However, given the other constraints that affect the overall allowed revenue, and the resulting material price shock, Hydro Tasmania considers that a more thorough review of depreciation options is merited as highlighted in our presentation on the 17^{th} October. Capex, opex and depreciation are considered in more detail in the remainder of this section.

Capex

Hydro Tasmania has set out its views on capex in its previous submissions. We note that the capex allowance is 25% higher than historical levels, and the Commission's concerns about Transend's ability to deliver these disbursements efficiently. We have highlighted previously the importance of the allowance reflecting the expected expenditure profile accurately, given the impact that this has on the overall revenue. For example, a 5 year delay in a capex project, while delivering the project within the revenue cap period, would have significantly overstated overall revenue with hindsight.

As noted in previous submissions, Hydro Tasmania has not had sufficient information available to it to comment on specific capex projects, and in particular on asset renewals. Nonetheless, we have carried out some desk-top studies to assess the impact of the Draft Decision on the ability of Transend to meet its obligations over the revenue cap period. Assuming that the probabilities assigned to the probabilistic component of capex are accurate[1], we estimate that the Commission's 10% reduction in capex results in an average delay of up to 6 months for the programme. While there has been debate about the assessment of risk in the development of the capex programme, a delay of six months would not seem to increase the risk profile of Transend its customers significantly.

Opex

Hydro Tasmania acknowledges that the Tasmanian electricity sector is entering a period of unprecedented change. Against this background, Transend, GHD and the Commission have sought to make reasonable efforts to forecast efficient opex over this period. Hydro Tasmania considers that the Commission has set the opex allowance at a level which sufficiently recognises the challenges faced by Transend over the next 5½ years.

Setting aside the grid support allowance, the Commission notes that it has provided on average an additional 16% opex when compared to the average opex between 1999/2000 and 2002/03, or an additional $4.3m pa. In their presentation to the Public Forum on the Draft Decision, MEG highlighted that Powerlink received an additional $2.4m pa in respect of Queensland's entry to the NEM. While we acknowledge that NEM entry will not be the only cost driver acting on Transend over the revenue cap period, we do consider that this provides comfort that the opex allowance in the Draft Decision is sufficient.

The treatment of grid support and SPS costs are discussed further in Section 4.

[1] Given that these have been prepared by Transend and reviewed by GHD, this is the only reasonable assumption that Hydro Tasmania can make at this stage.

Depreciation

Notwithstanding our comments above, initial analysis suggests that the Draft Decision results in a 60% average increase in revenue per annum for Transend, when compared to the existing control. Transend acknowledged these concerns on price levels in its presentation to the Public Forum, albeit arguing that their Application was nonetheless warranted.

The financial impact on network customers (and Hydro Tasmania[2]) arising from the Draft Decision will be significant and immediate. Furthermore, the implementation of Transend's pricing policy will have the scope to significantly affect individual outcomes, and this could result in above average increases for some customers. This impact could be minimised for customers without long term detriment to Transend through the Application of the competition depreciation approach described in the Draft Statement of Regulatory Principles (SORP). In the SORP, the Commission noted its concerns about straight line depreciation:

> *"In product pricing to the extent that depreciation is recognised as a cost of production along with the cost of capital and other input costs (in parallel with the cost of service approach), linear real depreciation would imply costs, and therefore prices, depend on the age of the productive assets being used (assuming no technological change). In a competitive market a much flatter time profile of pricing is observed relative to the age of the assets used to supply the goods or services. For example, the pricing of airline tickets bears little relation to the age of the aircraft used by the airline."*

In the SORP, the Commission proposed an approach which effectively replaced a pricing approach based on straight line depreciation with one based on an annuity. Depreciation in this model increases towards the end of the asset's life. In the case of Transend's revenue cap, given the findings on the other building blocks, and the constraints on the Commission in respect of valuation, application of a competition depreciation approach would mitigate the potential for price shocks for network customers. Amongst other things, a competition depreciation approach would:

- Reduce the return of capital in initial years, based on the assumption that it would be recovered in later years; and
- Increase the return on capital through a higher average regulatory asset base over the asset's life.

These effects are illustrated in Appendix A. The approach in Appendix A has been modelled on the figures in the Draft Decision with some simplifying assumptions. Furthermore, a full annuity approach has not been used - rather the resulting depreciation lies somewhere between straight line depreciation and that which would result from an annuity based approach.

[2] As described previously, Hydro Tasmania has a significant exposure to transmission charges on behalf of a number of MI Vesting customers.

While there are concerns about inter-generational equity with a competition depreciation approach[3], it would appear to be of particular advantage at times of rapidly increasing prices, given that it spreads the price impact over multiple revenue cap periods. This would be particularly useful given the impact of the likely increases in capex, opex and valuation that will result from the Commission's eventual decision.

Hydro Tasmania acknowledges that there are some implementation issues with this approach:

- TNSPs might be expected to be wary of this approach unless they were reassured about the probable approaches to the return of and return on capital in future revenue cap periods. For example, optimisation risk would be a particular concern for TNSPs in this regard.
- The underlying assumption is that capex and opex will plateau in future periods, or the competition depreciation approach would risk an almost exponential increase in charges in those periods. However, given the scale of increase in the Transend Application and the age/condition of their assets, this seems unlikely to be the result in Tasmania.

In its original Submission, Hydro Tasmania argued that the Commission defer some of Transend's revenue to mitigate the potential for price shocks. This proposal was not considered in the Draft Decision. The impact of adopting a competition depreciation approach on the Commission's programme for this revenue reset is also acknowledged. Nonetheless, Hydro Tasmania would strongly encourage the Commission to seriously explore this option as it finalises its decision.

3 Service Standards

Hydro Tasmania acknowledges the efforts of the Commission in respect of service standards. The service standard performance targets adopted in the Draft Decision should provide Transend with an adequate incentive to improve the technical performance of their network. We also value the Commission's comments in respect of the Customer Service Charter.

We further acknowledge that the collection of data for intra-regional constraints and average outage duration will allow the inclusion of incentives for these performance standards at the next reset. We are grateful to the Commission's staff for clarifying that network constraints that restrict the flows on Basslink will be included in calculations of intra-regional effects. On this basis, Hydro Tasmania endorses the Commission's approach to these matters. We would further encourage the Commission to monitor these two performance indicators over the revenue cap period to ensure that they do provide an adequate basis upon which to set targets at the time of the next revenue reset.

However, Hydro Tasmania notes the Commission's comments in discussing service standards:

[3] Based on an assumption that straight line depreciation is fairer in this regard, and addressed to some extent by the approach used in Appendix A.

"The ACCC and interested parties agree that the ACCC's draft service standard guidelines provide a practical starting point for the further development of the performance incentive scheme. It is recognised that the scheme will require improvements in the long-run to improve its overall effectiveness."

As would be expected, Hydro Tasmania will engage actively in the further development of these future service standards. In the meantime, Hydro Tasmania will continue to explore options with TNSPs to develop tailored enhanced service packages. The Commission's remarks in respect of the benefits of this approach have been particularly helpful in this regard, including for example:

"The ACCC also notes that Hydro Tasmania prefers an agreement regarding operations of the system protection scheme (SPS). Given the general benefits of the SPS scheme, the ACCC considers that an agreement between Hydro Tasmania and Transend would be beneficial. However it is a matter for the parties to negotiate."

While it is Hydro Tasmania's preference (consistent with the Code) to negotiate tailored service packages rather than rely on more general arrangements, it does not underestimate the practical difficulties in negotiating appropriate agreements with TNSPs. Hydro Tasmania will continue with its efforts in this regard. However, the success (or otherwise) of these negotiations should help inform decisions about the development of a regulated market based incentive scheme. For example, in the Draft Decision the Commission has focused exclusively on service standards that are technically based. Even the proposed developments contain no reflection of market value. To the extent that individual negotiations on enhanced access fail to deliver widespread agreements, we would encourage the Commission to develop market-based incentives as a matter of urgency.

Nonetheless, in the longer term, the ability for market participants to effectively negotiate and enter into commercial agreements for network solutions that meet their particular needs is essential. In this respect, the Commission's comments in the Draft Decision have provided clear guidance on the benefits of such negotiated schemes.

3 Commission's proposed alternative capex approach

Hydro Tasmania, prima facie, sees some merit in the ACCC's proposed alternative capex approach. In particular, there is benefit in ensuring that a specific customer supports the need for a particular connection project before the TNSP is allowed the revenue. While this could be argued to be contrary to the philosophy of incentive regulation, it does seem to ensure that the party who will bear the costs of the investment is actively involved in approving the expenditure. This must be preferable to the Commission or even the RNPP effectively taking decisions on behalf of project proponents.

As set out in our presentation at the Public Forum, there are a number of operational aspects of this approach that would require action prior to its adoption. These include:

- Identifying the specific projects that would be affected by the approach, and removing them from Transend's capex allowance in the Final Decision;
- Ensuring that a clear procedure is established which enables the pass-through of the associated revenues until the following price review, and including procedures for the associated revenues in future revenue caps;
- Ensuring that the relative negotiating advantage of the TNSP does not result in a higher level of capex that might otherwise have been the case.

Hydro Tasmania notes the theoretical and practical concerns expressed by Harding Katz on behalf of Transend at the Public Forum. In particular, there is a genuine concern that any approach adopted by the Commission should allow genuine connection projects to proceed and should allow Transend to recover the associated revenues, while still complying with the Code.

4 Detailed considerations

Hydro Tasmania wishes to clarify the Commission's position on two detailed matters.

Grid support costs
Hydro Tasmania notes that the Commission has provided an allowance in respect of Grid Support costs in the Draft Decision. As yet, Hydro Tasmania and Transend have not entered into preliminary negotiations in respect of Grid Support services and costs, although we understand that Transend are developing their requirements in this area. We consider it unlikely that these negotiations would be sufficiently developed to inform the Commission's Final Decision.

In any event, we understand that the Code envisages that network support services would arise out of the Application of the regulatory test for network augmentation. For example, Clause 5.6.2 provides:

> *"(m) Where the relevant Transmission Network Service Provider or Distribution Network Service Provider decides to implement a generation option as an alternative to network augmentation, the Network Service Provider must:*
>
> > *(1) register the generating unit with NEMMCO and specify that the generating unit may be periodically used to provide a network support function and will not be eligible to set spot prices when constrained on in accordance with clause 3.9.7; and*
> > *(2) include the cost of this network support service in the calculation of transmission service and distribution service prices determined in accordance with Chapter 6 of the Code."*

Given the early stage of negotiations, Hydro Tasmania is unclear as to the network augmentations that would be obviated by the operation of its plant. Equally, to the extent that Transend was able to avoid capital investment through the purchase of network support services, and given that they would be cheaper than the allowance for related capex in its revenue cap, Transend would have sufficient revenues to cover these network support costs already contained within the revenue cap. It is only at the next revenue reset that Transend would require an additional allowance to cover network support costs[4]. In this regard, the Commission's proposal to review actual expenditure appears merited.

SPS cost recovery
In our previous Submission, Hydro Tasmania recommended that SPS be treated as a regulated service. However, in the Draft Decision, the Commission discusses the treatment of SPS costs:

> *"In its application Transend states that it is currently working with Basslink Pty Ltd to install a system protection scheme (SPS). It states that SPS will ensure the security of the Tasmanian power system in the event of a transmission failure relating to Basslink. Transend claims that without the SPS its capex requirements would be much higher.*
>
> *GHD considers that the operational costs associated with Basslink should be directly recoverable from Basslink Pty Ltd. Hence it considers that costs associated with Basslink commissioning, maintenance of the SPS and communications for the SPS, totalling $4.39m, should be excluded from the revenue cap.*
>
> *The ACCC considers that the costs associated with the SPS could be regulated in a more light-handed manner, for example through a connection agreement between Basslink Pty Ltd and Transend."*

If this conclusion stands, it would be helpful if the Commission in its Final Decision was able to clarify further the extent of that light-handed regulation, including for example that:

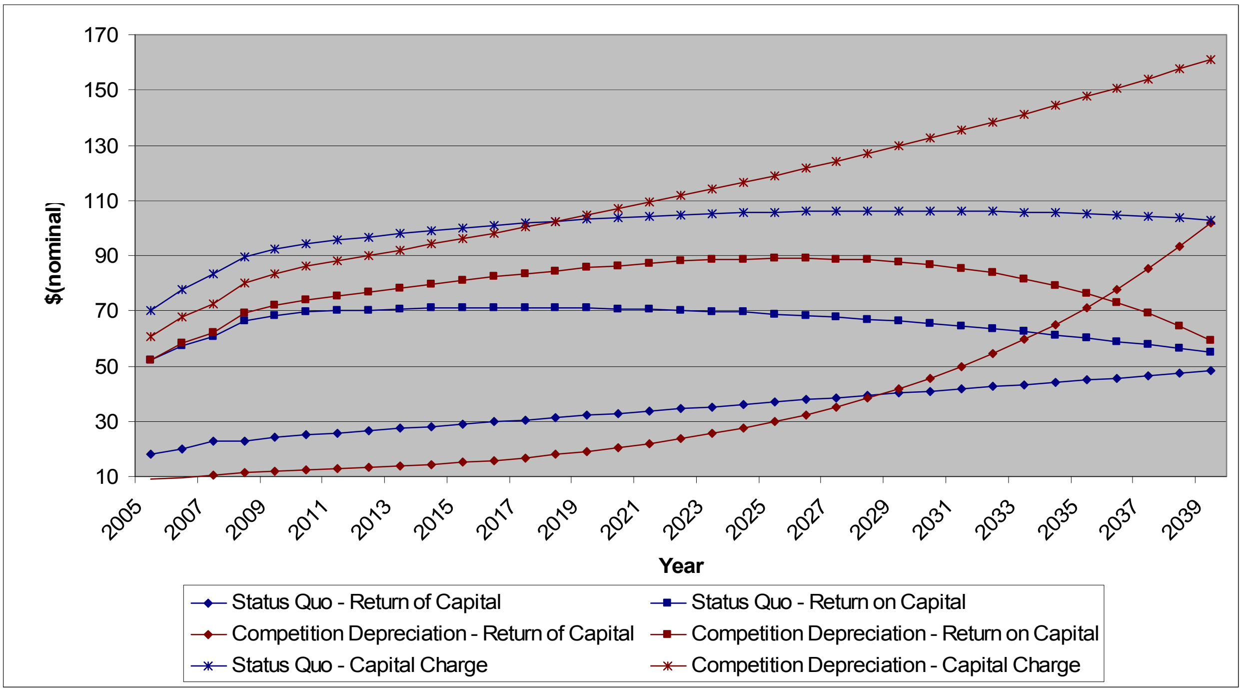
- The actual costs associated with Basslink Commissioning, SPS Maintenance and SPS Communications would be a matter for negotiation between the parties, and may in the event be lower than the forecasts set out in Transend's Application;
- Whatever its exact form, there is a Code compliant mechanism for Transend to retain the associated income recovered under the Connection Agreement with Basslink Pty Ltd, given that SPS has many of the characteristics of a prescribed service, and is clearly non-contestable;
- As SPS is non-contestable, whether there is a role of the Commission or other parties in determining 'fair and reasonable' terms, to the extent that Transend and Basslink Pty Ltd are unable to reach agreement; and
- That changes in ongoing operational costs, perhaps through new entry or network changes, should be the subject of further negotiation that reflects the benefits to each affected party.

[4] Assuming that the Commission did not clawback the capex allowance in respect of the avoided project at the next review, and assuming that the regulatory asset base at the next revenue reset excluded the asset value of the avoided network augmentation.

As the energy market in Tasmania develops, it may be desirable to update and develop SPS, perhaps even incurring capex. *Ex ante*, it is pure speculation as to which network users might benefit from these developments. Hydro Tasmania would consider it inappropriate to assume that future costs of this nature should automatically be allocated to Basslink Pty Ltd, simply on the basis of the initial Connection Agreement.

Appendix A

Graph: Competition and Straight Line Depreciation



General Assumptions (both scenarios)

- Post 30 June 2009 capex expenditure of $30m per annum
- Weighted average service life of 37.5 years
- Even capex spend profile across each year (50% of capex spend is depreciated in the year incurred)
- Return on Capital of 8.5%
- Discount Rate of 8.5%

Status Quo – Key Assumptions

- Capital expenditure and depreciation ("return on capital") as per Draft Decision
- Straight line depreciation

Competition Depreciation – Key Assumptions

- 50% reduction in depreciation in the first year
- Equalisation rate decreases depreciation reduction from 50% post year 1
- Equalisation rate recoups depreciation reduction in later years
- Depreciation is equalised (to straight line depreciation) over 35 years

Key Impacts of Competition Depreciation

- Depreciation is reduced for 23 years and recouped over 12 years
- Return on capital is greater under competition depreciation over the equalisation period.
- No net present cost to Transend of competition depreciation