11103

19 May 2003

Mr Sabesh Shivasabesan
ACCC
Canberra.
Email – sabesh.shivasabesan@accc.gov.au

Dear Sabesh,

Please find attached a formal submission from the Major Employers' Group in Tasmania to the matter of the current Transend Revenue Cap Application.

Regards

Terry Long
Chair
Major Employers' Group

2003 ACCC REVIEW

OF

THE TRANSEND REVENUE CAP

An assessment of the Transend Application

by

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for

Major Employers Group, Tasmania

May 2003

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Executive summary

In asking for a 50% increase from the level of regulated revenue set by the Office of the Tasmanian Electricity Regulator (OTTER) Transend fails in its application to substantiate the claimed annual revenues and the massive increase must therefore be seen as an ambit claim. It should be rejected by the ACCC.

There is insufficient information disclosure to enable the ACCC, let alone users, to assess the veracity of the claim or to satisfy users that the revenues sought are fair, reasonable and are reflective of economically efficient costs.

The very substantial information disclosure deficiencies include the following elements, which in any efficient and effective regulatory review, are regarded as minimal requirements necessary to justify or establish the merits of any access arrangement proposal:-

- information on electricity demand and volume changes for each major usage zone;
- an asset register and management plan;
- a detailed age profile of major assets;
- supportive material to establish the reasonableness of the significant and ambitious capex and opex claims;
- information on recent performance e.g. financial, benchmarks, load changes, benefits arising from previous capex, etc.

Transend's application also contains a highly over-stated asset base. Substantial amounts of the asset base appear to have already been fully depreciated in accordance with Transend's stated accounting practices. Transend's roll-forward of the asset base is also overstated, having only actually incurred some 70% of capex approved by OTTER in the previous regulatory period. There are also other significant anomalies, which cast serious doubts on the robustness of the dev elopement of the Regulatory Asset Base (RAB) claimed by Transend.

The application for a nominal WACC of 8.8% is highly ambitious. Not only does it substantially exceed all regulated returns approved by Australian regulators with regard to recent gas and electricity access reviews, but it is based on an inflated DORC asset valuation which cannot be justified and therefore substantially raises the monopoly rents proposed to be extracted by Transend.

Transend has made a highly ambitious claim, but has not provided a proper substantiation of the merits of is proposal. The ACCC has a duty to ensure that all claims are fair, reasonable and based on economically efficient costs. Anything beyond that must be rejected.

The intent of the TEC is that outcomes of the Regulatory process should mimic the competitive environment. In assessing Transend's application we request

that the ACCC take account of the following factors which would be present in a competitive environment and mitigate pricing increases:

1. Competitive pressure to minimise price rises.
2. Customer willingness to pay.

This submission provides our initial views on the Transend application and details areas where further information disclosure is required to assess the veracity and adequacy of the Transend claims.

1. Overview of the application

Transend's application seeks a significant 50% increase in regulated revenue above that set by the jurisdictional regulator, the Office of the Tasmanian Electricity Regulator (OTTER), in 1999. Yet the substantiation for the large increase is inadequate. Apart from a number of qualitative reasons, there is insufficient quantification and comparative analysis on which to substantiate Transend's revenue claims.

Specifically, Transend's application seeks to give the impression that its assets are in an extremely well-down state and, accordingly, a massive increase in the revenue cap is immediately required to remedy this situation, with further increases of a similar order required over the five year term of the access arrangement. These very large increases in revenues are to meet proposed substantial increases in capital as well as non-capital costs. However, although the application contains a certain amount of qualitative discussion to support its claim, a deeper independent assessment is difficult to make due to the extraordinary lack of quantitative data and the requisite information.

Such ambit claims – and they can only be described as such – cannot be accepted by the ACCC which has a duty, under the National Electricity Code, to ensure that stakeholders are provided with adequate information so that they are able to assess that the revenues sought are fair, reasonable, and are reflective of efficient costs.

This submission comments on those matters where Transend has provided sufficient information to enable considered commentary to be undertaken. However, there are significant elements where considered comment is not possible and these are noted, along with our reasoning.

2. Information disclosure

It is accepted that any network service provider, along with all profit-maximising enterprises, seeks to maximise its revenue stream and so provide its shareholders with the largest sustainable dividend. Costing of a service must provide sufficient return to maintain the enterprise's medium term viability. If the return sought is too high, a business in a competitive environment will suffer as competitors are drawn into the market, but if the return is too low, the enterprise will experience a lack of funds to maintain its business. Thus, in a competitive environment the disciplines of competition focus the approach of the service provider in developing its pricing structure, so as to allow it to continue to provide its service in the medium term, and to

operate in the most efficient way possible. Market disciplines drive an enterprise to moderate its approach when developing its pricing structure.

However, there are no such competitive pressures on monopoly network enterprises and economic regulation is seen as the surrogate for replicating a competitive market. Notwithstanding the accepted shortcomings of economic regulation, it is the agreed methodology under the National Electricity Code for reviewing the electricity transmission system and setting efficient prices. Regulation should provide the competitive rigor that is normally faced by enterprises in competitive markets. Thus, economic regulation must be equally as economically efficient as the pressures of real market competition.

One of the key requirements of competent and economically efficient regulation in access reviews is for informed input from a wide range of sources. One of the key sources of that input is from the parties who use the regulated services and are the ultimate providers of the revenue sought by the service provider. Failure to achieve informed input will result in poor outcomes, bringing dissatisfaction to interested parties leading to disputes.

Should there be insufficient information provided by the service provider, or if this information is declared to be “confidential”, then the ability of the “interested parties” to provide a countervailing argument (or undertake an independent evaluation) to that posed by the service provider is severely limited. By allowing a monopoly service provider to limit disclosure of information needed by interested parties to provide a competent response to an application for regulated revenues, the regulator can become exposed to perceptions of bias. Full disclosure of information to interested parties allows a strong and competent response to applications from regulated enterprises, and allows the regulator to act as an impartial umpire. On the other hand, as the amount of information disclosed reduces, the regulator can be seen by the regulated enterprise to take on the role of surrogate advocate for users and other stakeholders. It is of concern that service providers in general elect to minimise information disclosure, rather than face up to their obligation to be transparent and to fully justify claims before an impartial regulator.

It is all too obvious from Transend’s application that minimal effort has been made to provide all the requisite and needed information to justify or establish the merits of its proposals to either the ACCC or interested parties.

In particular, it is noted that Transend has not provided:-

- Information on electricity demand and volume (and anticipated changes) for each of the major usage zones. This information is required to assess the appropriateness of the proposed large capex sought (~$500m) as well as the size and allocation of opex requested ($35m pa).

- A detailed age profile of assets is needed to justify the asset replacement program. Transend has also failed to provide details of the depreciation rates used to calculate the economic depreciation claims. Transend asserts that its weighted age of all assets is 30 years old. But, what is required is a detailed breakdown of the type, location and age of the assets, as certain assets have a life expectancy considerably greater than the claimed average age of 30 years, whereas others of this age may well require replacement within another 5-10 years. The Age Profile provided by Transend (Fig 1.4) indicates that some substation assets are over 45 years old and still have a value despite supposedly having been fully depreciated over this period (Transend AR 2002 accounting notes 1(i)). In fact, reviewing the age profile provided by Transend indicates that there are some $170m of assets which are older than the fully depreciated lives indicated in Transend's accounting notes! This is a significant discrepancy and has far reaching implications.

- Transend's asset register and management plan. This will enable assessment of the capacity of the assets to provide the services anticipated over the regulatory period. Information is required to assess the levels of O&M required, as well as the capex proposed. There are also trade-offs involving capex and opex which need to be justified. Equally, there may not be a need to renew assets if their usage is declining, or if they are approaching redundancy. The ACCC and other Australian regulators have, to date, not failed to require the presentation of asset registers and management plans by access arrangement seekers as part of access reviews. Transend's application should not be treated as an exception.

- Quantitative data to support its claims for the massive injection of capex, i.e. there is not only a need to provide the underlying assumptions behind the many capex proposals but to carryout some cost/benefit analysis to demonstrate the need for the capex as the return on the capex is included in the annual revenue requirement. In particular, there is an allowance claimed for refurbishment, replacement and non network capex, but there is little explanation or justification provided for the amounts totalling some $220m.

- Past Capex. Transend has failed to provide details of the actual past expenditure of capex and the accompanying documentation demonstrating compliance with the regulatory test for expenditure over $1m.

- Information on its recent performance; financial, benchmarks, load changes, benefits arising from previous capex, should be provided for

comparison to the forecasts. Previous annual reports provide some of this data but there is insufficient breakdown of this data for reasonable investigation and comparison.

- A detailed breakdown of the "regulated opex forecasts". Currently opex is categorised into four main elements, with one sub element comprising 50% of the requested opex. None of these has been justified either by way of benchmarks against current expenditure in these categories, nor benchmarked against any similar enterprises, local or overseas.

- Transend has provided a number of tables showing amounts to be (ultimately) included in the regulated revenue path. However, little evidence is provided as to how these amounts are derived from other information included in the application.

Conclusion

The application by Transend is seriously deficient in information disclosure. The ACCC must require Transend to provide substantially more information, particularly with regard to the previous period, in a form which allows comparisons and benchmarks to be made.

Until Transend provides the required additional information any response to the application must be seen as preliminary. Provision of further information will permit a more comprehensive response to the issues.

3. Regulated Asset Base

The value placed on the Transend assets has been set by the relevant Minister in accordance with the Tasmanian Electricity Code (TEC) and the National Electricity Code (NEC). After undertaking analysis of the proposed RAB there is no doubt that the RAB set by the Minister has clearly overstated the value placed on the assets. Attached to this submission is a paper which demonstrates that the RAB (July 2001) value is overstated by at least $70m.

The TEC precludes the ACCC from reviewing the initial RAB set by the Minister. However, the ACCC would be remiss in not commenting that the RAB is blatantly overstated, particularly as it is now aware that some $170m of the assets included in the RAB set by the Minister have been fully depreciated already in accordance with the stated accounting practices of Transend.

Notwithstanding the constraints applied to a full and comprehensive review of the RAB by the ACCC, the ACCC has the responsibility to roll forward the RAB from the value set by the Minister to a January 2004 value. The

approach suggested by Transend is that the RAB set by the Minister should be augmented by capex and discounted for economic depreciation for the 30 months to January 2004.

As is typical of the Transend application, Transend fails to provide full details of the roll forward of the RAB from that set by the Minister for 7/2001. Transend provides no information as to the depreciation amounts used or of the inflation calculations. It includes for capex of $34m for 01/2002 but its 2002 Annual Report records capex of only $32.9m[1]. OTTER approved a capex amount of $52.2m for this same period[2] which demonstrates that Transend typically has a significant under spend of forecast capex.

In the four year period 1998 to 2002, OTTER approved the roll forward of $202.7m[3] ($7/98) into the capital base. In the same period Transend actually spent capex of $148.1m ($nominal), clearly indicating that Transend does not have the ability to incorporate capex at the rate forecast by them.

Transend has also declared that certain assets valued at an amount of $9.5m ($9.4m in 6/2001 and a further $0.1m in 6/2002) have been decommissioned. The value of these assets must therefore be deleted from the RAB roll forward.

Conclusion

The ACCC should only allow for capex that is actually incurred and demonstrably complies with the regulatory test when assessing the RAB roll forward. Transend should be required to revise the RAB roll forward calculation based on actual capex spent (actual capex for 02/2003 should be known by August 2003) and the deletion of decommissioned assets. The capex for the period 7/2003 to 12/2003 should be estimated based on past performance rather than using any inflated and unjustifiable forecasts.

4. Weighted Average Cost of Capital

The weighted average cost of capital (WACC) used by the ACCC must be seen in light of a number of aspects, viz:-

a. the inflated asset value, the valuation methodology used and the elements comprising it
b. returns achieved by businesses in a competitive environment and the basis under which these returns are calculated

[1] Transend Annual Report 2002 accounting note 9, reconciliation table

[2] OTTER, Investigation into Electricity Supply Industry Pricing Policies, Final Report, November 1999 table 5.6

[3] ibid, table 5.6

c. the risk profile of the regulated business
d. precedents used in earlier decisions
e. market inelasticity which gives security of return
f. asymmetric risk factors

In particular the risk free rate, the duration of the regulatory period, the MRP and equity asset beta have a major impact of the WACC.

Benchmarking returns

Comparisons of returns for regulated enterprises with those achieved by competitive enterprises can be readily done at the macro level, providing that comparable valuation methodologies for the assets involved are used. Equally, returns earned by enterprises operating in the competitive world should be greater than those for monopoly enterprises which face far less risk in achieving a reasonable return on funds employed. Thus, Transend should compare its planned return against the average of enterprises with a similar high capital base (such as many manufacturing enterprises), adjusting for the method for valuing funds employed (i.e. competitive industry assesses its assets based on depreciated historical cost – better known as DAC). Transend has built up the value of its asset base utilising the depreciated optimised replacement cost (DORC) which results in a higher asset valuation than the (properly depreciated) actual cost method used by publicly listed enterprises. The asset base out workings attached to this paper highlight the difference between the DAC and DORC valuations for Transend assets. The 2001 DAC is $422.9m and the proposed DORC value is $521.6m, an increase of 24%. On this basis, *just to account for the difference in valuation methodology,* the return for Transend should be 24% lower than for a business which uses the DAC methodology rather than the DORC asset valuation method. Transend seeks a nominal WACC of 8.8% on its DORC valuation. To achieve the same cash return a business using the DAC methodology would seek a weighted return of 11%. RioTinto plc, owner of Comalco, Transend's largest manufacturing customer, earned 8.6% return on its assets[4], well below the comparative level being sought by Transend. The returns earned by the other large customers connected to Transend confirm this incongruity.

If the Transend asset revaluation based on DORC was accounted for correctly, than the asset increase would have to be accounted for as profit, further extending the differential between the returns for Transend's customers in highly competitive industry compared to the highly secure revenue stream available to Transend.

[4] Pre tax ROA, source Rio Tinto plc Annual Report 2002

Transend risk profile and inelasticity of demand

The risk profile of Transend is very low, as it will be granted a guaranteed revenue stream for the next five years regardless of demand, and if it maintains its assets in a good operational order, it will have the right to similar guaranteed returns in future years. This is the low risk profile associated with being a regulated monopoly and there are many enterprises in Australia that would like to have this certainty of revenue without the risk of variable revenue they face on a daily basis.

The potential for Transend to be "bypassed" is almost nonexistent, confirming its low risk profile. Electricity demand is extraordinarily inelastic in the short to medium term and much of the current demand is inelastic in the long term. As Transend is guaranteed a revenue stream, it has a low exposure confined only to the loss of customers causing stranding of assets. Analysis of the energy usage of many of Transend's customers shows that electricity demand is inelastic in the long term.

Five year risk free rate

The ACCC's approach to using the five year government bond rate as the "risk free rate of return" is based on the sensible premise that as the regulatory period is five years then a regulated rate of return should be assessed against a risk free rate of a similar duration as the future risk exposure to both is comparable. Transend has requested the risk free rate be based on the 10 year bond rate as it purports this reflects the long duration of its investment.

That Transend has invested for a longer period than five years is not denied, but it should be noted that enterprises in competitive markets have their performance assessed over shorter periods than the 5 year window proposed, despite these enterprises having an expectation of a longer life due to the value of their assets. Some funds managers review corporate performance on a three month window, although most would assess performance over a 2-3 year period. Regulated enterprises would seem to be generously treated in comparison to enterprises in competitive markets whose revenues are not guaranteed in any way.

Further, such a view completely overlooks that many investments in the competitive world are made with a long term perspective (there are a number of manufacturing enterprises that have existed longer than Transend), but these enterprises still need to comply with the market signals appropriate to their operation. Transend application implies that it desires a new revenue review of its activities in five years, supporting the view that Transend should be consistent across the inputs to the WACC. More bluntly put, Transend prefers a 10 year bond rate as the five year bond rate is about 50 basis points lower than the 10 year rate.

Market risk premium

Transend (and its consultant, NECG) provides considerable discussion as to the market risk premium that should be applied to the CAPM calculation. The market risk premium sets an amount above the risk free rate to recognise that the investment of equity should receive a premium above the investment of debt. Transend avers that an MRP of 6% points is at the low end of a reasonable range for MRP.

What is deficient in the analysis is any comparison with businesses operating in a competitive environment and of assessments made by overseas regulators. A review of MRP awarded by overseas regulators (particularly the UK which uses incentive regulation similar to that which applies in Australia) shows that the MRP used in the UK is generally in the range 3-4%[5]. NERA confirms the conclusions[6] of Pareto and highlights that:-

> "It is also interesting to note the differences in declared equity premiums used by regulators in the UK and Australia. Australia's relatively high level of equity premium can be used to explain most of the difference in declared real post tax rates of return on equity in the UK and Australia."[7]

The Essential Services Commission of Victoria commissioned Mercer Investment Consulting[8] to provide input to the debate on MRP. Mercer comments that:-

> "For the purpose of this letter, having forecast long term Australian shares returns we have derived the *implied* ex-ante Australian shares ERP. Thus it is as an outworking of our forecast for Australian shares returns, we identified the arithmetic ERP to be 3.0%."[9]

In its presentation to the ACCC at the pre decision conference[10] on the SPI PowerNet application, the Energy Consumers Coalition of Victoria (EUCV) provided the following information.

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[5] The weighted average cost of capital for gas transmission services benchmarking regulated Australian and UK "vanilla" WACC components" for BHP Billiton June 2002 (Final Version) by Pareto Associates P/L

[6] International comparison of utilities' regulated post tax rates of return in: North America, the UK, and Australia, A Report Prepared by NERA March 2001 Sydney, Table 4.1

[7] ibid, page 19

[8] Mercer letter of 1 July 2002 to ESCV

[9] ibid page 5

[10] ACCC PDC conference on SPI PowerNet 14 Nov 2002

Av annual returns to 2002	ASX Accum index	5 yr bonds	10 yr bonds	Av MRP	Annual CPI Change
From 1989	9.9%	10.4%	11.5%	- 1%	3.2%
From 1997	10.3%	7.9%	9.4%	2%	2.6%

The outworking of this information supports the work of the other sources mentioned above.

On balance there is increasing evidence that the MRP used in earlier regulatory decisions is too high at 6% and a reduction to 3-4% is a much more appropriate range.

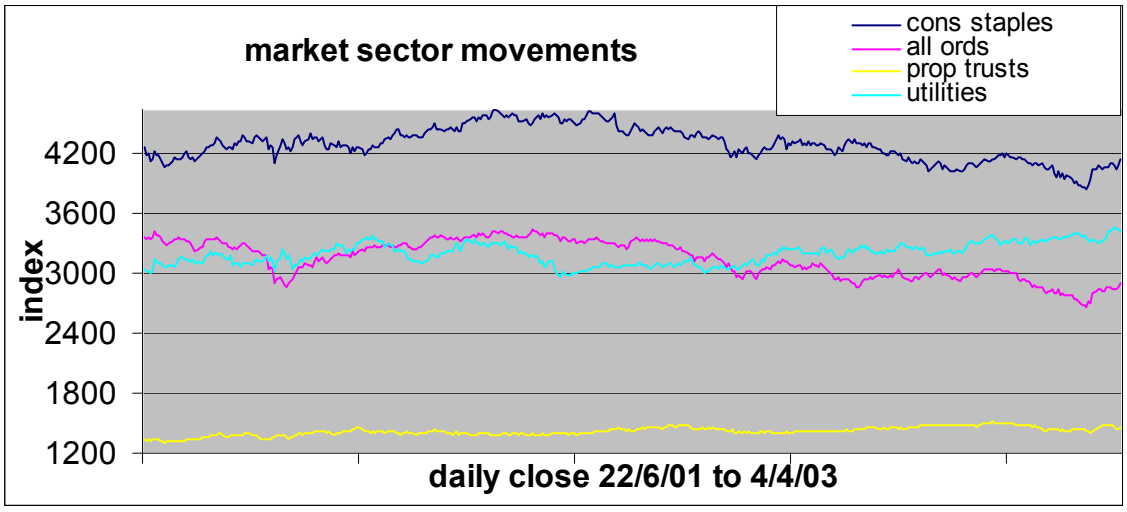
It has been stated that to reduce MRP from the current levels would introduce some regulatory "shock", but equally for consumers to continue to fund a higher than appropriate MRP denies the rights of consumers and raises the question as to whenever would be the right time to bring MRP to a more appropriate level. After all is not the National Competition Policy Reform (under Part IV A of the Trade Practices Act) about removing the abuse of monopoly power and excessive rents?

Equity beta

Equity beta is the element of the CAPM which allocates a weighting to the investment risk appropriate to the regulated business. In the recent ElectraNet and SPI PowerNet decisions, the ACCC set equity beta for these businesses at 1.00. Transend claims that it should have an equity beta of 1.12. The ACCC has accepted that using the equity beta calculated for the "Infrastructure and Utilities" sector of the ASX listing of public companies provides appropriate benchmark comparison.

This ASX sector has been discontinued and regulated utilities are now listed in the Utilities sector. Unfortunately this sector, whilst including some regulated businesses (eg AGL, United Energy, AlintaGas, Australian Pipeline Trust, Envestra, and GasNet) also includes stocks operating in the competitive market (eg, Energy Developments, Pacific Hydro, Geodynamics, etc) which biases the sector into the more speculative end of the spectrum. Despite this inherent bias a review of the sector since its establishment nearly two years ago is shown below[11]:

[11] Data source: Commonwealth Securities Ltd



A review of the chart shows that

- the "utilities index" is rising against a falling "all ords"
- the "consumer staples index" is more volatile than the "utilities index"
- the stable "property trust index" is rising against the "all ords" matching the rising "utilities index"

There would appear to be a strong case for the equity beta of the new "Utilities" sector to be significantly below the 1.00 currently used by the ACCC, probably closer to the range 0.4-0.50 applying to the property, and food and household (now consumer staples) sectors. There is little doubt that the stability of revenue stream from the regulated electricity businesses must be seen to be comparable to that from the property sector.

This recommended level of equity beta compares well to that used overseas. The Allen Consulting Group, in its July 2002 report[12] to the ACCC points out that gas transmission companies in the UK, Canada and the USA have average equity beta's of less than 0.3 (excluding companies with negative equity beta's, and that listed Australian companies involved in energy transport have an average equity beta's of less than 0.60. Whilst it is acknowledged that this report concentrates on gas transportation, it should also be recognised that electricity transport is a more revenue stable activity than gas, as gas transport companies accept the risk of volume whereas Australian electricity transmission businesses are provided with a fixed revenue cap, effectively eliminating volume risk.

[12] Empirical Evidence on Proxy Beta Values for Regulated Gas Transmission Activities, final report to ACCC July 2002

Based on this data there can be no doubt that an equity beta of 1.12 as requested by Transend is excessively high, and that the equity beta's used in recent decisions by the ACCC for electricity transmission businesses are also too high.

Conclusions

There can be no fundamental "right answer" to setting the WACC for a regulated business. Competitive pressure on a monopoly enterprise can only be applied by the use of comparisons to businesses in the competitive environment. It must be noted that the purpose of regulation is to replicate the outcomes of competition when applied to a business which is not subjected to the pressures of competition.

If a lower MRP (3-4%) and a lower equity beta (0.4-0.5) are used in calculating the WACC, the resultant calculation will demonstrate that the return on capital for Transend will more closely match the returns used by overseas regulators. But more importantly the WACC so calculated will be more comparable to the returns achieved by business in a competitive environment, particularly when adjustment is made for the different approaches to asset valuation methods.

5. Depreciation

Transend fails to provide any quantification of the calculations behind its depreciation schedule. A review of its Annual Reports indicates that its practice so far seems to provide for an asset life longer than those used by other electricity transmission companies. Its approach to depreciation of easements and way leaves is not provided.

Transend notes that it expects a number of assets will be stranded during the regulatory period but declines to state what these might be. They request that these should be fully depreciated at the next review. However, to follow such a path requires a demonstration that the assets were prudent and would pass the regulatory test at the time of their building. Further, the amount to be fully depreciated, first needs to be appropriately depreciated from the time of the investment.

The age profile provided by Transend is simplistic and does not provide a breakdown into the various categories Transend uses for its depreciation schedule. The graph itself is difficult to extract information from. However, it is quite clear that some $85m of assets are older than 60 years (ie should have been fully depreciated) and a further $95m of substation assets are older than 45 years and presumably should have been fully depreciated. On this basis it would appear that the average age of assets which should not have been fully depreciated would be about 20 years.

6. Capex

Transend has requested a "fixed" total capex of $330.8m be allowed into the regulated asset base. There is an additional amount of variable capex[13] noted of $160m, potentially increasing the total capex for the 5.5 year period to nearly $500m. When seen in context with an asset base of $521m, this implies Transend expects to nearly double the size of its asset base over the coming regulatory period!

This increase of 95% of capex/RAB compares with the recently approved (but considered high) capex/ RAB for ElectraNet of 43%, and a capex/RAB for PowerNet/VENCorp of 27%.

Historical capex

Capex is clearly needed to replace ageing assets and to accommodate growth. In some areas capex may be needed to improve reliability of the system to above current standards. Historical expenditure fully incorporates the first two areas of capex needs, and often includes some of the third. It is recognised that the introduction of NEM standards to Transend's operations *may* result in the need for some capex –Transend has advised that such work will require only $4.1m[14].

Transend has provided a little historical data on past demand and volume with its application. What is provided indicates that based on the past 10-12 years, the growth of demand and volume will match the forecast low growth scenario. In simplistic terms this means that the rate of capex should continue at a similar rate to the current actual (and similarly opex should stay at the same level). Using this basis the total capex that would appear to be needed should match historical levels with some additional capex for NEM entry. This would result in a capex requirement of perhaps $220m over the 5.5 year regulatory period. As Transend has not differentiated whether historical capex is related to new supply (recovered from generators) or new connections (recovered from customers), it would be appropriate to consider that this $220m is larger than the amount needed.

Capex overview

It is clear that Transend is seeking to include a massive expansion of its asset base during the regulatory period. Equally, the actual performance of completing capitals works, even when implicitly approved by the regulator, shows that Transend has completed less than 75% of the approved

[13] Transend requests that variable capex be added into the RAB as it is expended
[14] Transend application, table 6.3

expenditure[15]. In the current period, Transend expected to spend capex of $50m pa but failed to do so. In the new period, Transend is asking for a fixed amount of $60m pa *plus additional amounts for unidentified variable works.*

This raises the very real concern that Transend is seeking for the roll in of a very large amount of capex into the asset base (and gaining a return on the increase) without having the ability (or a fair expectation) to actually carryout the new works, and maintain sensible controls over the expenditure program and each activity within it. The capex cash flow for "fixed projects" is quite heavily weighted towards the early part of the regulatory period, creating not only concern that Transend does not have the resources to manage such large expenditure whilst complying with the Regulatory Test procedures, but that if this capex is deferred into the latter part of the regulatory period, Transend would have the earlier use of the approved but unearned revenue, resulting in a transfer of unearned funds from consumers.

Capex for development projects

Transend provides qualitative support for its development projects, augmented by the SKM review of the projects likely to be undertaken. There is insufficient quantitative analysis provided as to whether the cost of the development is justified to support the outcome.

Capex for the Southern Augmentation comprises funding from the development projects and from renewal capex. The project must be assessed under the Regulatory Test for major works and this analysis must include for all costs associated with the project, rather than just the amount included in the fixed development element of the capex. All projects greater than $1m in value must be verified as appropriate under the Regulatory Test.

Of the projects identified under "variable", most are related to new generation and Basslink. Under the principle of "user pays" none of these costs should be added to the RAB for funding by consumers. In particular, those projects associated with providing system security in the event of Basslink failure, must be allocated to the Basslink project and not rolled into the RAB.

There are some projects which are noted as being "shared" where the work is a result of new generation being added. Such work should not be added to the RAB.

Capex for renewal projects

The amount claimed as renewal projects is of a similar amount to the actual capex for the last four years. This indicates a significant increase over current

[15] Section 9 Performance Bonus shows that OTTER approved some $210.6m of capex for the current period to 6/02, but Transend only expended $154.5m in the period.

renewal capex. There is little quantitative justification for an amount which is two thirds of the total fixed capex requested to be rolled in.

Transend advises that it has used the probabilistic approach to capex setting, but this then transfers the risk of not expending the capex onto consumers. Transend can readily manage over expenditure on capital works, thus creating an asymmetric risk for consumers.

Capex for non-network

Transend has claimed nearly $27m for non-network capex, of which the major proportion is for relocation costs and includes an amount for a new control system.

The relocation expenses appear excessive in light of the numbers of staff, and there is no allowance included for disposal of no-longer needed assets.

The purchase of the new control system needs to be assessed as to what happens to it after NEMMCo commences management of the Tasmanian electricity market. If it then becomes redundant, there would appear to be little reason for its acquisition.

Conclusions

Transend has requested an extraordinarily high level of capex to be included into the regulatory program. There are real and justifiable concerns as to Transend's ability to properly manage such a high level of expenditure and an equally high concern that significant elements of the capex might not be expended during the period, resulting in Transend gaining unearned income.

Transend requires the actual expenditure incurred on variable development projects to be included retrospectively into the RAB as the expenditure is incurred and an adjustment made to the tariffs to recognise the actual spend on these projects. With this principle in mind, there would appear to be no reason not to so similarly adjust the actual expenditure on all capex. Transend notes that it wants the fixed elements of the capex fully included so that it incentivises Transend to minimise expenditure. The Regulatory Test is designed to do exactly this and as most of the capex will require the Regulatory Test to be applied (for projects > $1m) to justify the expenditure, there would appear to be little reason to further incentivise Transend to minimise capex.

7. Opex

Transend has requested an opex which averages in constant dollar terms some $35m per annum. Included in this amount is the System Controller function which transfers to NEMMCo when Tasmania joins the NEM.

In the Annual Reports for the last four years Transend details its annual operating costs for the past four years and these averaged[16] $18.8m plus $8.6m for system control[17]. It is interesting to note that on a constant dollar basis the historical opex is consistently a similar amount each year, with little annual variation.

There are three key issues arising from the comparison between actual costs and those claimed in the application:-

- Allowing system control costs of $8.6m (as detailed in the Transend Annual Reports for 2001 and 2002) means Transend is claiming opex of $26.4m pa for managing its transmission system. This is an increase of 40% above its average costs for the past four years.
- Transend has made no allowance for the system operating costs to be deleted from its opex from the time NEMMCo commences managing the Tasmanian electricity market. Whilst the date for connection is still unknown, Transend must build into its AARR a mechanism for the system control costs to be removed at the time the transfer takes place.
- As mentioned in the section on capex, the growth forecasts in demand and volume essentially replicate the growth experienced over the past 12 years. This supports the view that current opex levels are all that is needed to match the changes the business expects over the new regulatory period.

Due to the lack of any breakdown of historical opex, it is impossible to further analyse the opex claim in any detail other than in a qualitative way. Transend must be required to provide a break down of the historical opex so that it can be matched to the claimed opex allowances.

<u>NEM entry</u>

Transend avers that it will incur extensive costs as a result of participating in the NEM. There is no attempt to provide any cost substantiation for these supposedly new costs. A review of them indicates that mostly these services are already effectively being provided under the current regulatory regime or will have little cost impact. It should be remembered that integrating with the NEM is meant to reduce costs, not become a vehicle for claiming increased allowances.

<u>Connections and development</u>

A review of the activities of this group does not indicate any increase in duties that they already do as part of their normal functions for the TEM. The change in reporting on these functions should not lead to an increase in the costs they

[16] The opex costs have been escalated to bring them to the same base as the application

[17] In its 1999 Decision OTTER included a budget of $3.3 ($02) for Transend to carryout this function

will incur above what should already be carried out by an efficient organisation.

Network group

A review of the activities of this group shows little change from what should be current activities.

It is pleasing to note that the group indicates an active approach to reducing outages. However, to include for an increase in opex to achieve this outcome and then to reward it through the incentive scheme implies a double dip, and this is not acceptable.

Transmission operations group

Currently the system control function of Transend costs $8.6m pa. When this function is transferred to NEMMCo, it appears that Transend costs only fall by $4.3m pa, requiring Transend to retain a cost element of $4.3m pa. Of concern is that Transend assumes that it will incur regulated costs associated with the operations of Basslink. Basslink should reimburse Transend for the costs it causes Transend to incur.

Not only are the amounts included for this group quite significant but there is no clarity as to what they provide for. Transend must be more forthcoming with the breakdown of the costs involved and the activities (and costs) being transferred to other parties such as NEMMCo.

Corporate group

The corporate group indicates it will have a cost structure of nearly $8m pa. This is compared to a current total opex level of $27.4m pa. This means that the corporate group will cost about one third of the current operating expenditure. This is an extraordinary level of overhead costs. The ratio of corporate expense to claimed opex is 20% whereas competitive businesses target to operate closer to 5%.

Other costs

Transend has claimed that it is entitled to equity rasing costs of $0.6m pa, despite the fact that it has not had to raise any equity, and has been given debt free the assets of the transmission system.

Transend proposes that certain opex been classed as “pass through”, including excess insurance costs and grid support. There is little detail provided as the expected magnitude of the risks faced by consumers by allowing this practice, and more detail is required to assess the impact of this proposal.

The issue of energy metering needs more explanation, including an indication as the likely costs involved and the reasons why Transend might incur such costs.

Conclusions

There is very limited data made available by Transend for any comment other than a high level qualitative review. Further whereas OTTER built into its decision on opex for efficiency gains, Transend has elected to delete this regulatory feature of implicit and continuous improvement. Competitive businesses are being continually being driven to reduce costs, but the application by Transend exemplifies the regulated business belief that it is already operating at the most efficient level and that further cost savings are not possible.

In its decision, OTTER permitted Transend a lesser amount for opex than Transend reports in its Annual Reports, indicating that Transend incurs costs outside the regulated activities of the business. However, there is no information made available which allows an assessment of what elements of the Transend current costs should not be included in the regulated opex.

On the basis of the information made available it would indicate that Transend has little or no justification for increasing its costs above current actual levels.

8. Benchmarking

Benchmarking in Australian regulatory reviews

The importance of using benchmarking in regulatory reviews cannot be over stated. In the absence of true competition, the regulator must use performance benchmarks for comparing the costs of a regulated business against best practice – this is the concept of “competition by comparison”. There appears to be a trend amongst regulators to accept that if the performance benchmark is within the range of a group of similar businesses, then there is an acceptance of the proposals put by the regulated business. This being the case, regulated businesses are able to identify those similar businesses with equal or worse performance and so demonstrate that their allowances are reasonable. Thus, users are levied for charges which lie within the lower performance range.

The preferred position is that regulated businesses should be permitted allowances which lie in the upper quartile of performance, driving the business towards best practice, rather than allowing consumers to pay a premium for continuing the poor to average performance.

In Australia, there are few electricity transmission businesses but the current practice is for all to compare their performance only against each other. If

each business is assessed to be within the range of other Australian businesses, then ultimately there will be a trend for the performance benchmarks to be circular, and competition by comparison effectively ceases. What users seek is for the regulated business to be driven towards the higher performance range – towards world's best practice. To achieve this goal requires the regulator and the regulated business to include in the comparisons of performance, data from decisions given by overseas regulators on similar regulated businesses. Failure to include such benchmarks will consign Australian electricity users to mediocre performance with the resultant cost penalties.

Extreme care needs to taken when assessing benchmark performance. Selecting different controls for measuring performance can result in apparently major discrepancies and distortions. Whilst a wide range of performance measures should be benchmarked, granting weight to the outcomes needs to be carefully carried out.

Benchmarking by a business seeking increased funds is usually biased to demonstrate the need. It is therefore important to ensure that benchmarks used for regulatory purposes are consistent across all businesses when comparing performance benchmarks.

The Transend application

Transend has commissioned a consultant to benchmark[18] Transend's proposed cost structure. Transend draws from this work certain benchmarks to demonstrate the reasonableness of the increase of its costs from current levels. Intriguingly in some benchmarks Transend has elected to modify the approach used by other transmission businesses and use the supply side capacity rather than use the demand and volume parameters of the Transend service as the basis for comparison. As Transend points out[19] the installed capacity connected to Transend is nearly 60% above the level of demand. Using this approach distorts the benchmark significantly.

Transend notes that because of the seasonality of its supply the network must be sized to allow the full capacity of each of the generation units. This is no different to other networks which likewise must have this capability. If this was not the case then generators in a competitive market could justifiably complain about there being insufficient access to the regional markets.

Transend fails to note that despite there being a large surplus generating capacity in Tasmania, the load factor of Tasmania's demand is one of the highest of all Australian transmission networks.

[18] Transend application, appendix 2
[19] ibid, figure 1.3

Transend notes that this seasonality and dam levels impact on the ability and timing for Transend to carry out needed maintenance on its network. This is not so much a factor justifying an exorbitant RAB or for arguing for higher capex and opex allowances, but one which explains the apparent poor performance which Transend notes but attributes to a low cost structure[20].

It should be remembered that the Transend network is required to service the need of the demand side, not the aspirations of the supply side. Transend avers that this change in approach is driven by the relatively large number of small generation units within the system. Whilst it is true that other Australian systems have a smaller number of large generation units, they also have large numbers of smaller units both embedded in the distribution systems and directly connected to the transmission system.

The approach by Transend to use supply side capacity as the basis for comparison is not sustained by the facts. Further, as noted above, a review of the location of the additional generation units shows that the additional line length required to service the units is modest at best. Countervailing this apparent drawback, the Transend system is located in a compact geographical location, giving significant benefits over other Australian networks such as PowerLink and ElectraNet.

Transend notes that in comparisons under the ITOMS composite measure, the performance of Transend assets from HEC days has improved remarkably[21]. It should be noted that this improvement came about under capex and opex costs well below those now being sought. Transend then attempts to throw doubt on the adequacy of the ITOMS approach, despite the fact that it is used widely as the basis for measuring performance, particularly by all other Australian transmission businesses.

Transend concludes that service levels recorded by Transend lag those of other Australian transmission businesses (despite Transend being average on the ITOMS measure) and that this is attributed entirely to a lack of capex and opex. Transend fails to mention that there are other factors causing the noted lower standard, including seasonality impacts and dam levels mentioned above, terrain and weather. Analysis of outages on a feeder basis would provide a better indicator of the cause of lower performance and cost needs rather than using a single global figure.

<u>Conclusions</u>

In the recent reviews by the ACCC, it applied a range of benchmarks to the cost structure of the regulated business. Using this approach and a consistent

[20] Transend application figure 1.7, and accompanying comment
[21] ibid, figure 1.8, and accompanying comment

set of benchmark performance measures tends to ensure a uniformity and consistency of views about each transmission business.

Transend has selectively used different benchmarks to justify its claims for increased capex and opex.

9. Performance Bonus

In principle the concept of reward for out-performance is supported. The risk to consumers who pay the reward is that the target performance should be challenging to the business and that the rewards and penalties need to reflect both the benefits/detriments to consumers, the ability of the provider to take the risk of underperformance and the cost to the provider to achieve out-performance.

However analysis of the Transend proposals is made difficult due to the lack of detailed information of the cost drivers to demonstrate the appropriateness of the proposed structure. One element this is clearly absent is equality in setting rewards and penalties. In our view the penalty to the business should be equal to the bonus possible to be received.

Transend claims that it exceeded the performance requirements set by OTTER and that a performance bonus should be rolled in to the AARR. It is recommended that OTTER should be requested to assess the legitimacy of the amount (if any) to be rolled into the AARR to recognise any over/under performance of the benchmark set by it.

However, Transend was permitted by OTTER to include for amounts for capex for the four year period 1998 to 2002. This is compared to actual spend[22] as follows:-

$m (nom)	98-99	99-00	00-01	01-02	total
Allowed capex[23]	59.6	48.5	44.8	57.7	210.6
Actual capex	53.4	38.2	30.0	32.9	154.5
Annual under-run	6.2	10.3	14.8	24.8	56.1

Conclusions

More information is required to understand the proposal for the penalty/bonus arrangement for achievement of service standard. In particular the penalty bonus arrangement needs to be symmetrical.

[22] Transend Annual Reports 1999, 2000, 2001, 2002

[23] Escalated at CPI

The impact of this continuing under-run of capex has been an aggregate over payment to Transend in its AARR allowance, of nearly $10m. This amount needs to be recovered from Transend and redistributed to consumers.

OTTER should review the claimed performance bonus to assess its validity.

10. Conclusions

Information disclosure
The application by Transend is deficient in information disclosures. The ACCC must require Transend to provide substantially more information, particularly with regard to the previous period, in a form which allows comparisons with the current application.

Regulated Asset Base
The ACCC should only include for the capex spend actually incurred when assessing the RAB roll forward. Transend should be required to revise the RAB roll forward calculation based on actual capex spend (actual capex for 2002/03 should be known by August 2003) and the deletion of decommissioned assets. The capex for the period 7/2003 to 12/2003 should be estimated based on past performance rather than using any inflated forecasts.

If it considers that the RAB is overstated (as we strongly do) the ACCC should advise the Minister of its view.

Weighted Average Cost of Capital
The MRP and equity beta used by Transend are too high.

A lower MRP (3-4%) and lower equity beta (0.4-0.5) should be used in calculating the WACC, and the resultant calculation will demonstrate that the return on capital for Transend will more closely match the returns used by overseas regulators, but more importantly the WACC so calculated will be more comparable to the returns achieved by business in a competitive environment.

Depreciation
Transend fails to provide any quantification of the calculations behind its depreciation schedule.

Some $85m of assets are older than 60 years (ie should have been fully depreciated) and a further $95m of substation assets are older than 45 years and presumably also should have been fully depreciated.

Capex
Transend has requested an extraordinarily high level of capex to be included into the regulatory program. There are real and justifiable concerns as to Transend ability to properly manage such a high level of expenditure and an equally high concern that significant elements of the capex might not be expended during the period, resulting in Transend gaining unearned income.

Opex
There is very limited data made available by Transend for any comment other than at a high level qualitative review. What information is made available indicates that Transend has little or no justification for increasing its costs above current actual levels.

In its decision OTTER permitted Transend a lesser amount for opex than Transend reports in its Annual Reports, indicating that Transend may incur costs outside the regulated activities of the business. However there is no information made available which allows an assessment of what elements of the Transend current costs should not be included in the regulated opex.

Benchmarking
In the recent reviews by the ACCC, it applied a range of benchmarks to the cost structure of the regulated business. Using this approach and a consistent set of benchmark performance measures ensures a uniformity and consistency of views about each transmission business. Transend has selectively used different benchmarks in an attempt to justify its request for increased capex and opex

Performance Bonus
More information is required to understand the proposal for the penalty/bonus arrangement for achievement of service standard. In particular the penalty bonus arrangement needs to be symmetrical.

The impact of the continuing under-run of capex has been an aggregate over payment to Transend in its AARR allowance, of nearly $10m ($6/02). This amount needs to be recovered from Transend and redistributed to consumers.

OTTER should review the claimed performance bonus to assess its legitimacy.

ACCC REVIEW OF TRANSEND REVENUE CAP

An assessment of the Transend Asset Value

by Headberry Partners P/L and Bob Lim & Co P/L

for the Major Employers Group, Tasmania

1. Methods used for calculating the regulatory asset base (RAB)

There has been continuing debate about how to establish the value of monopoly assets. The national Gas Code explicitly recognises this and sets the upper and lower bounds for asset valuation. The upper bound is that calculated by the depreciated optimised replacement cost (DORC) method which is a quite subjective analysis and therefore results in quite variable conclusions, with different parties achieving different answers. The lower bound is that set by the depreciated actual cost (DAC) method, which is a factual method and used almost universally by competitive industry.

The DORC method allows for carry forward of RAB between regulatory periods by using the previous base, reducing it by economic depreciation (allowed depreciation less inflation), adjusting for optimising the assets, and adding approved capex. This is the approach used by OTTER and by the ACCC.

Comparison to valuations of RAB for transmission assets in other jurisdictions, even allowing for Transend's unique features, indicates that the value claimed in the application by Transend for its RAB is clearly excessive.

2. The Transend directors' valuation of assets

A review of the Transend annual reports provides some very useful information as to a more appropriate value for the Transend assets.

In its Annual Report of 2001, the directors of Transend state in the balance sheet that its DORC value of "plant, property and equipment" is $432.7m[24], work in progress is $19m[25] and that is has an asset revaluation reserve of $37.6m[26] included in the calculated DORC value of $432.7m.

There is no clarity about what constitutes the "asset valuation reserve" and there have been four annual additions to it since 1998. However, normal business practice is that where an asset is revalued, the increase (or decrease) is taken to

[24] Transend AR 2001, Financial Note 9
[25] ibid, table of reconciliation
[26] ibid financial note 14

account as a profit (or loss). Transend has appropriately taken the full amount of depreciation of the assets to account as an "expense" but the increase in value has not been taken as income and has subsequently been declared as a "change in equity" after being added to the post tax profit. This practice allows Transend to artificially increase its asset value without impacting on its profit and loss position. The benefit to Transend of following this approach allows it to claim an inflated asset value for regulatory purposes as it claims the RAB should include the asset valuation reserve, but allowing Transend to avoid paying tax on the asset value increase.

The absurdity of this approach is clearly demonstrated in its Annual Report of 2002, where the asset value for the purposes for accounting is effectively $406.5m[27], and at the same point in time the asset valuation reserve of $155.7m is valued at about 40% of the accounting value of the Transend assets. This means that Transend directors are adding 40% to the Transend asset value without declaring this as a corporate profit, and therefore this approach is clearly for the purposes of artificially inflating its RAB.

In the four years from July 1998 to June 2002, the value of Transend assets has been adjusted as follows[28]:

July 1998 directors' valuation	$329.6m
Less decommissioned assets	$ 9.5m
Adjusted July 1998 value	$320.1m
Less accumulated depreciation	$ 56.7m
July 1998 value depreciated to June 2002	$263.4m
Plus capital injections	$154.5m
Less depreciation on capex	$ 11.7m
Plus accumulated asset valuation reserves	$155.7m
June 2002 directors' valuation	$562.2m[29]

Thus, over the period Transend has been operating, the Transend directors are of the view that the value of the assets transferred to it from the HECT (as adjusted for decommissioned assets and depreciation) has **increased in value by 59% in four years.** Over the same four year period, inflation amounted to just 13.7%.

This massive increase in value over such a short time has few equals as an investment class, easily exceeding the growth in utility stocks which show an

[27] Transend AR 2002 asset value $562.2m (financial note 9) less asset valuation reserve $155.7m (financial note 14)

[28] Source of these calculations is Transend annual reports 1999, 2000, 2001 and 2002, asset reconciliation tables in the financial notes.

[29] Addition is not consistent by $0.3m due to rounding errors and minor amounts not included

average 5% annual increase over the past two years. The absurdity of this asset revaluation approach is that if left unchecked, the asset valuation reserve will ultimately exceed the value of assets under management.

3. Different calculations for RAB.

As mentioned earlier industry uses the DAC approach to valuing its assets and its calculated returns use this figure. Use of a DORC basis for asset value therefore should recognise the alternative valuation basis and adjust downward the return (or weighted average cost of capital WACC) used to calculate the return on capital. Unfortunately regulators do compare WACC with the actual returns competitive industry achieves so use of DORC valuation effectively leads to an inflated revenue return on capital.

In the case of Transend, there are a number of ways the RAB can be calculated. In the following six calculations, where the base asset value used is that set when Transend was formed in 1998 – $329.6m[30] as at 1 July 1998. The actual cost of additions and disposals included are as detailed in Transend annual reports, allowing where needed an a average depreciation life for all assets of 55 years, and all groups eight cities CPI changes as used by the RBA.

Using different approaches for the calculation of RAB shows that at 30 June 2001 with regard to the Transend RAB ($6/01), the following values result

Transend AR 2001[31]	$395.1m
DAC basis	$422.9m
DORC basis	$459.0m
OTTER[32,33]	$447.0m

These are compared to the asset values suggested in the Transend application

SKM[34]	$563.2m
Minister/Meritec[35]	$521.6m

The conclusions that can be drawn from this analysis are

1. There is some consistency between the DAC valuation approach and the Transend valuation excluding the asset valuation reserve component

[30] Transend Annual Report 1999, page 23, financial note 7
[31] Transend Annual Report 2001, financial note 9. Asset value is $432.7m including an asset valuation reserve of $37.6m
[32] OTTER decision 1999, Table 5.6, adjusted for inflation, actual capex spend and decommissioning of assets as reported by Transend AR 2001
[33] OTTER valuation based on SKM assessment July 1999, including the impact of decommissioning assets
[34] Transend application page 32
[35] ibid, page 32

2. That no two DORC assessments are consistent
3. The change in SKM calculation of asset values between 1999 and 2001 appears to give the later value an increase of 25% above the earlier value
4. The method of carry forward impacts the calculation
5. The valuation proposed by the Minister is not consistent with the independent assessment made only two years earlier by OTTER.

4. Is Transend correct that the Minister sets the RAB?

In its application, Transend avers that the minister sets the RAB for the Transend assets, prior to regulation commencing by the ACCC.

The National Electricity Code states that

> "subject to clauses 6.2.3(d)(4)(i) and (ii), assets (also known as "sunk assets") in existence and generally in service on 1 July 1999 are valued at the value determined by the *Jurisdictional Regulator* or consistent with the regulatory asset base established in the *participating jurisdiction* provided that the value of these existing assets must not exceed the *deprival value* of the assets and the *ACCC* may require the opening asset values to be independently verified through a process agreed to by the National Competition Commission;" [36]

The import of this clause is that the ACCC should use the asset valuation established by the jurisdiction. In this regard the Jurisdictional Regulator (OTTER) has already established an asset value which was included in its decision in November 1999. This asset value has been calculated in accordance with the rules established by the Participating Jurisdiction (the Tasmanian Government) and the amount established by OTTER does not exceed the deprival value of the assets.

The Tasmanian Electricity Code permits over-riding the National Code requirements by allowing that

> "For the purposes of the regulation of *distribution network* service pricing and *transmission network* service pricing in the *industry* an order made or deemed to be made in accordance with the Electricity Supply Industry (Price Control) Regulations 1998 shall be deemed to be a determination under and made in accordance with Chapter 6." [37]

Thus there is scope for the Minister to use the regulations appended to the Electricity Supply Industry Act 1995, to over-ride the decision of OTTER in regard to valuing the Transend assets prior to the regulation being transferred to the ACCC. The exercise of this power is of concern as it can be taken to imply a lack

[36] National Electricity Code clause 6.2.3(d)(4)(iii)
[37] Tasmanian Electricity Code clause 13.6.1

of confidence in OTTER and its processes, and it is seen as a decision of the shareholder of Transend to arbitrarily use its power to the benefit of Transend.

5. Conclusions and Recommendation.

Based on this analysis the later valuations by SKM and Meritec show a carry forward of an inflated value for the Transend assets. If either of these values is used, this will significantly increase tariffs above current levels.

In November 1999, after an exhaustive analysis, OTTER determined the asset base for Transend. This strongly independent valuation is in stark contrast to the value proposed by the Minister, who as the “shareholding Minister” may have a vested interest in maximising the Transend asset value. There is a strong argument that the asset value set by OTTER in 1999 is appropriate and shows some consistency with comparable valuations for other transmission networks.

The OTTER asset value was set only two years prior to the Minister’s valuation and over this time the asset base appears to have been artificially inflated by over $70m (or 16%) on a comparative basis. Using the nominal return proposed by Transend this increase in asset base will result in Transend revenue increasing by over $6m per annum. This increase in revenue is effectively unearned being brought about only by an artificial increase in asset base.

It is quite apparent that the Minister has used his power of determination of the Transend asset base which has been to the detriment of electricity consumers, and by overturning the asset value set by OTTER, is denying that the independent regulator has previously exercised its judgement in a sound fashion.

6. Outcomes of an inflated asset base

If Transend is permitted to increase its RAB by the amount determined by the Minister, this will effectively lead to an unearned increase in Transend revenue by 8% and as the volume of electricity passing through Transend assets has remained flat, this increase is directly translatable to an 8% increase in Transend tariffs.

The later work of SKM and Meritec is not consistent with either the earlier work by SKM or even Transend’s own accounting practices, and to use the later work by SKM or Meritec will only add unreasonable and unnecessary costs to electricity consumers who have no option to using the Transend transmission system.

It is therefore recommended that the suggested Transend asset value is reviewed in light of this work, and either

1. The Transend asset value is calculated by OTTER building on the work carried out by it in November 1999, or
2. Permit the ACCC to calculate an asset value for Transend based on the November 1999 OTTER decision on the Transend revenue cap.