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By email sebastian.roberts@accc.gov.au

Dear Sebastian,

ACCC Draft Decision on NSW and ACT Transmission Network Revenue Caps

SPI PowerNet wishes to address some issues raised in the ACCC Draft Decision on the *NSW and ACT Transmission Network Revenue Caps – TransGrid 2004/05-2008/09*. In doing so, the Company has focused on issues that affect TNSPs generally rather than TransGrid specifically. In particular, SPI PowerNet has made comments in the following areas:

- the cost of capital setting process;
- the debt credit rating benchmark;
- efficiency sharing and the 2% efficiency factor; and
- the use of benchmarking.

While these represent the key areas of concern to SPI PowerNet arising from the Draft Decision, our response is not exhaustive.

Cost of capital

The TransGrid Decision will constitute the first revenue decision in the second round of decisions under NEC regulation with the ACCC as regulator. Therefore, there is an expectation that the parameters of this decision will be rolled out across the other TNSP decisions of the second round ending with the Transend Decision in 2008/09, the only variation between decisions being changes to market variables such as the real and nominal risk free rates and the debt margin. This is, in effect, what transpired during the first round of revenue cap decisions (excepting the initial TransGrid Decision) despite the substantial amounts of new evidence on WACC being submitted both by the ACCC and participants during this time.

If this expectation is accurate, then the ACCC should consider changes to both its Draft Decision and the Draft *Statement of Regulatory Principles* (SRP) during the current review. These changes would consist of:

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- explicitly recognising in the Final Decision the expectation that the WACC outcome will apply to all second round revenue cap decisions; and/or

- formalising one WACC review for each round of decisions rather than at each TNSP Decision in the SRP. This would address participant concerns that much evidence has to be resubmitted and debated during each decision process causing considerable duplication of effort and cost. This is valid concern considering these submissions did not achieve any movement in a parameter during the first round of decisions (excepting the Australian Competition Tribunal Decision on the 5 year/10 year bond issue). It would also allow a sufficient period of time for new market evidence to accumulate. Once the WACC parameters for the round were established, following reviews would only need to measure the risk free rates, the debt margin and provide the desired measurement period.

Benchmark credit rating

SPI PowerNet notes the continued use of the A+ credit rating as the benchmark when setting the debt margin. This is calculated using a sample of companies that generally have the backing of Government ownership or are not stand-alone entities (that is, they have the backing of a parent company).

SPI PowerNet has stated previously that use of this sample without adjusting for these factors results in a distorted benchmark rating. SPI PowerNet believes that after adjusting for these factors the calculated rating would be A- or BBB+.

The ACCC dismisses this argument stating, "government/parent ownership is only one factor which may affect a credit rating and would not create a significant bias to the sample." However, SPI PowerNet believes that, for a given level of gearing, it is the dominant factor and is, therefore, not so easily dismissed.

One possible resolution to this issue would be obtain shadow ratings from the rating agencies for the various businesses on a stand-alone basis.

Efficiency benefit sharing

The ACCC provides a description of the current process for setting the opex allowance in the Draft Decision.

> "The key features of this arrangement are as follows:
> - The opex allowance for the coming regulatory control period is established at the start of the period;
> - There is no opportunity to re-visit the allowance once established. In this respect it is quite different to the treatment of capex which is subject to ex-post prudency assessment; and
> - The opex target is reset at the subsequent review but there is no requirement or obligation on the ACCC to consider the outcome from the previous period in establishing the starting point or target for the next period." (p. 24)

SPI PowerNet would agree with the above description, however, the ACCC then addresses the issue of efficiency benefit sharing in future regulatory periods. The description continues:

> "In addition, in the current regime there is no explicit efficiency carry-forward mechanism. In other words, the ACCC is free to decide at the end of the Regulatory Period to pass on the full amount of any revealed efficiency to customers by reducing the opex target in the coming period by the full amount of those efficiency savings." (p. 24)

While this may have been the case for the initial 1999 TransGrid Decision, which was finalised in the absence of the Draft SRP, SPI PowerNet believes that, contrary to the above statement, there is a clear sharing mechanism outlined in the Draft SRP and has always understood that it is currently operating under that regime. Indeed this sharing mechanism was applied in SPI PowerNet's own 2002 Decision. Statement S7.2 in the Draft SRP states:

> "Benefits will be glide pathed for a five year period commencing at the start of each regulatory review.
>
> The Commission will make the following adjustments at the end of each regulatory period, to apply in the next regulatory period:
> …
> - Operations and maintenance expenditure – straight line glide path over the next regulatory period; …" (p. 97)

A more detailed description of the mechanism is provided on pages 90-91 of the Draft SRP:

> "This form of glide path allows for the gradual sharing of the benefits of efficiency gains between users and the TNSP in the form of lower prices. Further, for reasons of simplicity the glide path will be a simple straight-line phase out of efficiency gains. That is, for a regulatory period of five years, efficiency gains beyond the X factor would reduce at a rate of 20 per cent per year. Thus, the TNSP will keep 100 per cent of excess efficiency gains for the first year of the next regulatory period, 80 per cent of the excess efficiency gains for the second year, and so on, until all of the excess efficiency gains are phased out by the end of the regulatory period."

SPI PowerNet recognises that the ACCC is currently consulting on changes to the regulatory regime for opex to more formally link future opex expenditures with the efficiency sharing mechanism. However, it has always been assumed this would apply to future regulatory periods rather than the current period.

SPI PowerNet believes this should be clarified in the Final Decision or during the current review of the Draft SRP.

The efficiency factor

SPI PowerNet is concerned with the incorporation of a 2% efficiency factor in TransGrid's approved opex allowance. The ACCC justifies this inclusion because:

- TransGrid's large capital investments should start to reduce capex as new assets replace older ones;
- the 2% efficiency factor is consistent with TransGrid's historical internal efficiency targets, though these have not been achieved;
- the 2% efficiency factor on opex has a precedent in the Transend Decision;

- in other countries where incentive regulation has been applied over a long period, large real reductions in opex have been achieved.

SPI PowerNet agrees that the replacement of an old piece of equipment with newer equipment when combined with many of the new monitoring and support systems will generally decrease the maintenance requirements of the business, all other things being equal. However, this ignores the fact that the network continues to age over the regulatory period with more equipment reaching the high maintenance end of its technical life. This is best represented by the average age of the network equipment. Thus, it is possible that increased capital expenditure does not result in a net reduction in old high maintenance equipment.

As an example, although SPI PowerNet has increased its replacement capital expenditure considerably during the current regulatory period its networks average age will continue to increase. Indeed, SPI PowerNet would have to spend close to $100 million per year in replacement capital expenditure for the average age to start to decline significantly. Therefore, as TransGrid's network is of a similar age to SPI PowerNet's it should not be unexpected that TransGrid has more not less equipment reaching a high maintenance period in its life despite the capital expenditure taking place.

It should also be remembered that large operational expenditures such as vegetation management on easements will not be affected by a replacement capex program.

The key point is that, when combined with the increasing size of the network, a TNSP's opex forecasts already incorporate the productivity improvements the ACCC is seeking to impose with its 2% efficiency factor. Thus, the factor becomes an additional impost on the TNSP for which it will not receive the benefit of its hard work to achieve it.

To provide additional support for its use of this efficiency factor, the ACCC makes reference to an internal efficiency benchmark and the fact it wasn't achieved. This appears to contradict the ACCC's previous statements that its preference is to use historical outcomes as a major input into setting future benchmarks. For example, on page 24 it refers to its current review of the SRP:

> "During the current regulatory period, the ACCC has consulted on changes to the regulatory regime for opex that could entail prescribing at the start of the regulatory control, how any revealed efficiencies will be taken into account in establishing future opex allowances at the time of the subsequent controls."

These previous statements should suggest that a company failing to achieve a benchmark level would weaken the case for using it in future not support its use. Given that TransGrid has already received a penalty for overspending it opex allowance in the previous period by being unable to recover it in future periods, this additional imposition of a further efficiency factor appears to introduce a worrying asymmetry into the incentive regime.

Reference is also made to the precedent of Transend Final Decision. This remains problematic if being used to strengthen the case for the use of such a factor in the TransGrid Draft Decision as other precedents do not contain an explicit efficiency factor (although they do contain productivity increases) and the reasons given in Transend Decision provide no better basis for its inclusion.

Much is also made of overseas experience. However, SPI PowerNet believes the key lesson from overseas regulation is that incentives work if allowed to and not second-guessed by the regulator.

In conclusion, irrespective of whether it is realistically achievable, the imposition of an arbitrary 2% efficiency factor compromises the incentive properties of the regime as the TNSP is no longer able to share in these efficiency benefits. SPI PowerNet believes this expressly contradicts the intentions of the NEC and should be removed in the ACCC's Final Decision.

Benchmarking

The ACCC has included various benchmarks as part of the Final Decision. This reflects the increasing prominence given to benchmarks evident in the ACCC's more recent Revenue Decisions. While SPI PowerNet recognises the ACCC's qualifications attached to its analysis, the Company believes there are some severe weaknesses in the chosen benchmarks and offers the following brief comments and suggestions. SPI PowerNet also provides its own performance under a benchmark it is commenting on so its interests are clearly declared. Nonetheless, SPI PowerNet believes its comments are relevant and would improve the ACCC benchmarking if acted upon. While SPI PowerNet has a contribution to make on a broad range of benchmarking issues it has limited its comments to benchmarks included in the Draft Decision.

Separately, SPI PowerNet believes that a TNSP working group on benchmarking be constituted along the lines of the current Service Standard Working Group to allow the ACCC access to expertise lacking in its current analysis.

<u>Expenditure Ratios against the RAB</u>

SPI PowerNet believes the undepreciated replacement cost of the asset base is the appropriate value to use for any comparisons of opex or capex ratios. This is because the replacement cost provides a more accurate representation of the different size of the TNSPs than the depreciated bases currently being used by the ACCC (and therefore the different size opex task facing them). It is understood that the TNSPs have or are willing to supply their replacement cost value (that matched the regulatory value) to the ACCC for this purpose. Please note, that SPI PowerNet performs very well under the current asset ratio benchmarks.

The simplified example below illustrates why the depreciated asset value is unsuited to benchmarking.

Company A has an asset base with a replacement cost of $100 million now depreciated to $10 million. Company B has a newer asset base with a replacement cost of $30 million depreciated to $20 million. Ignoring economies of scale and the age related costs of its older asset base, Company A would be expected to require around 3 times the opex than Company B as it is 3 times bigger. However, using the benchmarks used by the ACCC implies that Company B will need the higher opex. Use of such a benchmark will cause particular confusion amongst customer groups if they try to impute relative efficiencies from the ACCC results.

In addition, SPI PowerNet believes easement costs should be excluded from the asset values being used for the comparison for the following reasons.

Firstly, the asset value of the lines is a broad indicator (as is km of lines, also used by ACCC) of the opex task facing a TNSP removing the need to use the easement value.

Secondly and more seriously, each TNSP has had a very different valuation methodology applied to their easements. For example, TransGrid has an ODRC value, Powerlink has an imputed historical cost value, SPI PowerNet has a historical cost value based on actual records while ElectraNet has an incomplete residual value only. This obviously creates a large yet artificial boost to TransGrid's asset base relative to ElectraNet's when constructing the benchmarking ratios.

Removal of the easement values is a simple exercise as they are clearly identified in the TNSP's regulatory accounts.

Opex per Substation

A TNSP's assets can be divided into towers and lines assets and substation assets. Using these subsets of assets, the ACCC provides two benchmarks, opex per line length and opex per substation. Please note, that SPI PowerNet performs badly on the opex per substation measure.

While ignoring many other important cost factors (such as voltage and geography), the line length in km can be a broad proxy for the opex task facing a TNSP in maintaining its lines.

Unfortunately, the number of substations does not provide the equivalent representation of the opex task facing a TNSP in maintaining its substation assets, indeed, it does not represent anything relevant to a TNSPs costs. This is because substations differ markedly in size between TNSPs and is, therefore, largely irrelevant when assessing this opex task. Opex is obviously more closely related to actual number of pieces of equipment needing to be maintained.

A more appropriate measure would be would be opex per transformers installed or better still, opex per number of maintenance units (Switchbays, transformers, reactive plant). The number of transformers installed is publicly available information contained in the ESAA Publication Electricity Australia. Total number of maintenance units could be supplied by the TNSPs, if sought (and was provided by SPI PowerNet during its Revenue Determination).

This resulting measure, again recognising that it would be far from perfect, would then at least be equivalent to the opex per lines benchmark.

If you have any questions on the issues outlined above please call SPI PowerNet's Regulation Manager, Tom Hallam on 8635 7335.

Yours sincerely,

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