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Dear Sir

Comments on ACCC's Powerlink Draft Revenue Cap Determination - July 2001

I refer to the application from Powerlink Queensland to the ACCC for a determination of their transmission network revenue cap commencing January 2002. In general, TransGrid is supportive of most aspects of the approach taken by the ACCC in their draft determination of Powerlink's Revenue. However, there are some matters, including those set out below, that require further consideration.

1. Asset Valuation

We note the position taken by experts at various ACCC conferences supporting the principles of Optimised Depreciated Replacement Costs (ODRC) for valuing assets of regulated businesses. We also note the general support of this principle set out in the ACCC's draft Statement of Regulatory Principles document.

Accordingly, TransGrid is still encouraging the ACCC to adopt an ODRC valuation approach to easements. In principle, the economic arguments for use of ODRC valuation to other assets should equally apply to easement valuation.

2. Regulated Rates of Return

TransGrid is concerned that the ACCC's draft target return on equity of 11.71% is still too low. We would like the ACCC to consider, in particular, comments made by the Productivity Commission in their recent Position Paper entitled " Review of the National Access Regime". From a public benefit perspective, it is more desirable that investments in essential infrastructure proceed than it is to eliminate all elements of excessive returns to the owners of these assets.   The Productivity Commission also argued in the same report that "The provision of a reasonable return would in turn help to 'reassure' potential investors in other essential facilities that the access regime would give proper regard to investment needs" (pp.145-6).

TransGrid notes that the ACCC has yet to acknowledge the Productivity Commission's views in the Draft decision, and would welcome an appropriate recognition of this view in the Final determination. TransGrid would like to draw the ACCC's attention to an international paper (see attached) on this issue in the January/February 2001 edition of *The Electricity Journal* entitled "Assessing the Cost of Capital for a Standalone Transmission Company" by Messrs Michael Cragg, William Lehr, and Ron Rudkin. In essence, the article argues that the "social costs of setting return on equity for transmission companies too low are likely to be greater than the social costs of setting return in equity too high".

<u>Selection of Bond rate</u>: We note that the ACCC at the time of the TransGrid decision did not come to a landing on what should be the ACCC's final decision on the appropriate bond rate. Nevertheless, the resulting revenue cap was based on a 10-year bond rate. Subsequently, it seems the ACCC has moved towards a 5-year bond rate.

In terms of consistency, TransGrid would caution the ACCC and other regulators in moving to a five year bond rate, if other parameters that constitute CAPM parameters are based on a longer time frame. Should the ACCC adopt the shorter timeframe, work performed by Professor Grundy[1] strongly argues that there is a need for both the Market Risk Premium and the margin on corporate debt to be increased by the historical average difference between the 5 and 10 year bond rates. In the absence of this adjustment the ACCC, to maintain internal consistency between CAPM parameters, should continue to use the 10-year bond rate.

TransGrid would support PB Associates' review in arguing that (Section 3.4.2, *page 30*) interest during construction calculations should be the Vanilla WACC rate that utilises returns on debt and equity rather than the 6.5 per cent used by Arthur Andersen. This approach recognises that major capital projects are funded by a combination of debt and equity aimed at maintaining a TNSP's overall debt to equity targets.

Furthermore, TransGrid does not accept ACCC arguments that it has fully integrated the effects of asymmetric risks into its assessment of regulated returns. While we acknowledge that the pass through of increases in insurance costs partly addresses this issue, we do not believe that different aspects of optimisation and regulatory risk, and the risks associated with certain potential increases in future costs (which includes higher service standards and changes in the functional operating environment) are being fully compensated for and quantified in current levels of regulated returns.

The relative immaturity of transmission regulation in Australia remains risky in that regulatory principles are still evolving, as is the legal framework in which the ACCC operates. In this context it is worth noting the risks identified by the Productivity Commission's Position Paper at page 58.

TransGrid agrees with the continued adoption of insurance pass-through (Section 5.3.2) processes, to be consistent with the approach adopted in our revenue determination process.

3. Service Standards

Based on our experience with transmission service provision over many years, we would endorse Powerlink's comments on the benefits of applying statistical analysis in support of targets set for transmission service performance. Indeed, the most valuable measures are often those developed by transmission businesses over time that, although not directly reflective of customer impact, provide vital information about service performance trends.

TransGrid agrees that transmission service obligations and actual performance targets should be determined as part of the revenue reset process involving the ACCC and the respective

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[1] *See the Attachment to TransGrid's Submission to the ACCC on the Snowy Mountains Hydro-Electric Authority Transmission Network Revenue Cap 1999/00 – 2003/04: - Draft Decision (14 July 2000).*

TNSP. TransGrid also agrees with the ACCC's current position that it is inappropriate to impose a set of financial indicators linked to Service Standards. Similarly, TransGrid would agree with Powerlink that performance should not be measured against statistically "non-valid" performance targets.

TransGrid continues to strongly endorse Powerlink's comments that TNSPs should only be held accountable for areas of performance over which they have control. In this regard, TransGrid would draw ACCC's attention to a typographical error in Section 7.5 "Submissions by interested parties" which requires correction. Currently the second paragraph reads as follows:

> *"TransGrid supports both Powerlink's statistical analysis approach to setting service standards and suggests that TNSPs should only be held accountable for areas of performance over which it does* ***not*** *have control".*

The sentence should read as follows: -

> *"TransGrid supports both Powerlink's statistical analysis approach to setting service standards and suggests that TNSPs should only be held accountable for areas of performance over which it does have control".*

Furthermore, the on-going influence of NEMMCO decisions on transmission capability needs to be fully recognised. There is also a clear link between the ability for transmission companies to make appropriate planning and investment decisions, and the service levels that they can provide.

Yours faithfully

Philip Gall
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