11October 2002

Mr Michael Rawstron
General Manager
Regulatory Affairs - Electricity
Australian Competition and Consumer Commission
PO Box 1199
DICKSON ACT 2602

Dear Mr Rawstron

Submission regarding the ACCC's draft decision on ElectraNet's revenue cap

The Australian Competition and Consumer Commission (ACCC) released its draft decision on ElectraNet's revenue cap in September 2002 ("the draft decision"), and subsequently held a public forum for interested parties on Friday 4 October. Transend attended the public forum and verbally presented its views on a number of regulatory policy issues. We welcome this further opportunity to express Transend's views in writing as part of the ACCC's formal submission process.

This submission is deliberately focussed on issues of regulatory policy and principle, rather than the detail of ElectraNet's cost estimates and resource requirements. We believe that the ACCC, its consultants and customers are much better placed than Transend to scrutinise ElectraNet's cost estimates.

Instead, this submission focuses on those aspects of the draft decision that have broader implications for the future regulation of transmission revenue. In our view the draft decision raises a number of important issues regarding the ACCC's approach to regulation. Although these matters essentially concern regulatory policy, the ACCC's approach to these issues could have a material impact on its revenue cap decisions. It is therefore timely that these policy matters should be addressed by the ACCC as it works towards its final decision on ElectraNet's revenue requirements.

There are four particular issues on which Transend wishes to comment:

1. Approach to operating expenditure;
2. Exclusion of costs associated with distributed generation;
3. Clawback of capital expenditure under-spend; and
4. Treatment of capital and operating expenditure.

This submission deals with each in turn.

1. Approach to forecasting operating expenditure

The ACCC rightly comments[1] that the regulatory framework should provide incentives for managers to pursue ongoing efficiency gains through cost reductions. The objective of providing TNSPs with efficiency incentives is a critical element of CPI-X regulation. Transend strongly supports regulation that encourages and rewards efficiency improvements.

However, there is considerable risk if this efficiency objective is interpreted as requiring year-on-year decreases in operating expenditure. Firstly, it is unrealistic to expect any business to deliver annual reductions in operating expenditure ad infinitum. In our view, the ACCC and the transmission businesses share joint responsibility for managing stakeholder expectations regarding the scope for on-going cost and price reductions. The regulatory framework will ultimately be subject to criticism unless customers, regulators and transmission companies share realistic expectations regarding future cost reductions.

Secondly, it is important to note that an "efficiency improvement" is not synonymous with "cost reduction". This distinction is particularly important in the current environment where customers are expecting further improvements in transmission network performance. The scope for service improvements is severely constrained if operating costs are required to fall year-on-year.

The definition of efficiency was recently addressed by the Panel which was appointed to consider company appeals against the Office of the Regulator-General's (the Office) 2001 electricity distribution price review. The Panel commented on the approach to efficiency adopted by the Office of the Regulator-General ("the Office") as follows[2]:

> The Panel notes that the Office measured efficiency by comparing actual total costs (including operating and maintenance costs, and capital costs) as achieved in 1999 with the benchmark forecasts, for the distribution business, for that year. The Panel recognised that this comparison does not make any allowance for changes in the size or scope of the business from those which were assumed in the benchmark forecast.
>
> In the Panel's view this results in a measure which does not reflect efficiency as normally understood, and which creates incentives for the distribution business to perform inefficiently.
>
> According to the rule of thumb [applied by the Office], a cost increase necessitated by an increase in output is treated as a reduction in efficiency. A reduction in the size of the business results in a reduction in cost and thus a measured increase in efficiency, entailing a reward to the business in future years through the efficiency carry over mechanism.

[1] ACCC's draft decision on ElectraNet's revenue cap, page 3
[2] Extract from the Office of the Regulator-General's Redetermination, December 2000, page 4.

> The Panel decided that the use of a rule of thumb to measure efficiency which did not make allowance for changes in scale and scope of the business constituted an error of fact in a material respect. Accordingly, the Panel decided to set aside the Determination and remit it to the Office for amendment of the Determination….

It is worth emphasising the Panel's view that due consideration should be given to changes in the size or scope of a business. An increase in the scope of business activities would ordinarily necessitate an increase in operating costs. Transend notes that ElectraNet has identified numerous changes in their future scope of activities. However, the draft decision does not provide a detailed examination of these claims. Our view is that these changes in scope are essential aspects of the operating expenditure forecasts and a robust analysis of comparative efficiency.

Transend notes that the draft decision relies heavily on ratio analysis and a consideration of historic costs to assess the reasonableness of ElectraNet's operating expenditure forecasts. The ACCC comments[3] that it prefers to use efficient costs rather than the company's actual costs.

In our view, however, there is a strong relationship between efficient costs and actual costs which should be carefully examined by the ACCC. In particular, incentive regulation implies that actual costs will be driven by management to their efficient level. It is therefore highly likely that observed differences between TNSPs' actual costs do not reflect differences in their relative efficiency. Instead, these differences in actual costs more likely reflect their diverse operational characteristics, including energy density, load factor, scale and reliability.

In our view, the ratio analysis adopted by the ACCC does not adequately identify the impact of these important operational issues on observed costs. Instead, it tends to assume (incorrectly) that the observed differences in actual costs equate to differences in efficiency. This assumption tends to place ElectraNet at a comparative disadvantage.

From a practical perspective, a more robust approach would assume as a starting position that actual costs equate to efficient costs for the scope of work undertaken. Any subsequent changes in scope (whether increases or decreases from historic levels) need to be considered in detail to forecast efficient cost levels for subsequent regulatory periods. In our view, this sort of approach would be more consistent with the ACCC's draft Statement of Regulatory Principles which comments[4]:

> The Commission depends on information provided by the TNSP to establish forecasts of operating and maintenance costs, which are passed on directly to the revenue cap for the regulatory period ahead. As a check on the information the Commission will have over time access to the audited historic accounts of the TNSP and benchmark estimates of productivity growth in operating and maintenance expenditures for similar operations. However, on the whole the Commission is not well placed to judge the true potential for productivity gains within a particular TNSP. The accomplishment of any savings in

[3] ACCC's draft decision on ElectraNet's revenue cap, page 110

[4] ACCC's draft Statement of Regulatory Principles, page 94.

> operating and maintenance expenditure greater than forecast goes straight to the bottom line of the TNSP's accounts, hence there is a strong incentive on the part of the TNSP to understate the potential for prospective operating and maintenance savings. Nevertheless, once those savings are realised the regulator is better placed to re-set operating and maintenance forecasts for the following regulatory period based on what it has observed.

2. Exclusion of costs associated with distributed generation

The draft decision notes that ElectraNet has proposed a significant level of expenditure to facilitate the future connection of distributed generation, primarily wind driven. There are essentially four arguments presented in the draft decision[5] for disallowing the inclusion of this expenditure:

- The high costs of such projects while their benefits are unclear;
- The Code is unclear about who should pay for such augmentations;
- Locational signals may be lost if generators are not required to pay; and
- The overall size of the project allows ElectraNet to re-prioritise its capital expenditure program.

Transend notes that the draft decision also includes ElectraNet's response to some of these arguments, which were initially presented by Meritec. ElectraNet comment[6]:

> ElectraNet considers that Meritec has confused the issue of funding projects through ElectraNet's revenue allowance with recovery of this revenue allowance through customer transmission charges. It considers that Meritec has not understood the requirements of the code in relation to transmission pricing.

Transend agrees entirely with ElectraNet's observation. It is important to distinguish between three separate processes:

a. The market benefits test which ensures that only projects that maximise net market benefits are allowed to proceed;

b. The revenue cap process which estimates (amongst other things) the amount of capital expenditure required in the forthcoming regulatory period; and

c. The pricing arrangements by which the TNSP recovers its regulated revenue from generation and load.

Firstly, it should be noted that the National Electricity Code adopts a shallow connection approach which strictly limits the extent to which the costs of network investment can be directly allocated to generators as connection assets. Transend therefore expects that the significant majority of capital expenditure associated with distributed generation would be treated as shared network assets, and subject to the pricing arrangements set out in the Code. These pricing arrangements establish the beneficiary pays principle for achieving

[5] ACCC's draft decision on ElectraNet's revenue cap, page 76
[6] ACCC's draft decision on ElectraNet's revenue cap, page 70

cost recovery, and these arrangements are entirely independent of the revenue cap process.

On this basis, Transend believes that process (c) is entirely independent of the revenue cap process (b). This independence means that arguments presented in the draft decision regarding pricing signals or "who should pay for transmission" are not relevant to the revenue cap decision. In our view, it is therefore incorrect to cite pricing issues as a reason for disallowing capital expenditure estimates.

It is recognised that there is an indirect link between process (a) and (b). In particular, the revenue cap should include a capital expenditure allowance that reflects the forecast cost of projects that will proceed. A number of TNSPs have adopted a probabilistic approach to estimating these costs. Implicitly, this approach identifies projects that would pass the market benefits test if particular load growth and generation scenarios eventuated.

In our view, the ACCC has inappropriately assumed that no capital expenditure project associated with distributed generation will pass the market benefits test. Transend does not believe that this is a realistic assumption or that it is appropriate to second-guess the outcome of the market benefits test in this way. Instead, the likelihood of projects proceeding should be addressed in the context of the probabilistic approach to capital expenditure forecasts.

Transend strongly supports a forecasting or regulatory mechanism that addresses the inherent uncertainty in forecasting future capital expenditure requirements. Our view is that the arguments presented by the ACCCC in disallowing capital costs associated with distributed generation are not soundly based. In our view, the ACCC should carefully re-examine this issue as it works towards its final decision.

3. Clawback of capital expenditure under-spend

The draft decision quotes Meritec's review of ElectraNet's capital expenditure forecasts as follows[7]:

> Meritec considers that acceptance of a capex forecast prepared under a probabilistic approach essentially gives the proponent permission to spend that quantity on projects which are not necessarily identified at that stage, albeit subject to a regulatory test prior to preceding. It notes that the approach proposed by the Commission in its DRP for making adjustments of over estimates of capex is the clawback mechanism. Meritec believes that this is effective for relatively small variations between approved and actual expenditure, however, if large variations from the expected level are experienced it may be more difficult to recover these by clawback.

Transend is particularly concerned that this statement implies that the ACCC would clawback regulated revenue where capital expenditure was less than the forecast amount.

[7] ACCC's draft decision on ElectraNet's revenue cap, page 57

The ACCC's draft Statement of Regulatory Principles (SoRP) makes no reference to such a clawback mechanism. The only adjustment for capital expenditure underspend contemplated in the draft SoRP is a prospective one (as opposed to a retrospective adjustment) to the asset base and depreciation allowances to reflect the actual level of capital expenditure. The draft SoRP specifically states[8]:

> The Commission does not favour a framework that claws back past revenues.

It is important that the ACCC clarifies its approach to this issue so that stakeholders are provided with clear guidance on the regulator's preferred approach.

4. Treatment of capital and operating expenditure

Transend supports the ACCC's approach to the treatment of refurbishment expenditure which seeks to ensure that TNSPs are not exposed to unwarranted write-downs as part of the DORC valuation process.

Notwithstanding our support, it is important that the ACCC allows TNSPs sufficient flexibility to address their particular accounting issues, whilst maintaining the principle that the accounting treatment should be cost and revenue neutral. In making this observation, we are particularly conscious of the complexity of these issues and the need to adopt a pragmatic and flexible approach at this early stage.

If you would like to discuss any aspect of this submission in further detail, please do not hesitate to contact me on email: stephen.clark@transend.com.au or telephone: 03 6278 6126.

Yours sincerely

Stephen Clark
A/General Manager Connections and Development

[8] ACCC's draft Statement of Regulatory Principles, page 36.