ACCC Public Forum

Draft Decision:
Tasmanian Network Revenue Cap
2004-2008/09

Friday 17 October 2003

Main messages

- The ACCC’s Draft Determination relies on two myths
  1. Transend has put forward an ambit revenue claim
  2. Substantial efficiency gains can be obtained

- Transend understands some criticism made by interested parties and concerns on price levels

- The consequences of the Draft Decision will remain for a very long time

- There’s a joint responsibility on all of us to understand the facts objectively

Myth: Transend is making an ambit revenue claim

- The Tasmanian energy sector is changing:
  - look to the future, don't rely on the past

- Increased revenue needs driven by:
  - Inappropriately low
    - starting asset base
    - starting opex base
  - Large increase in activities since 1 July 1998
  - Change in cost recovery mechanism for system control
  - Future scope changes: NEM entry, wind, gas
  - Old network in poor condition, requiring augmentation

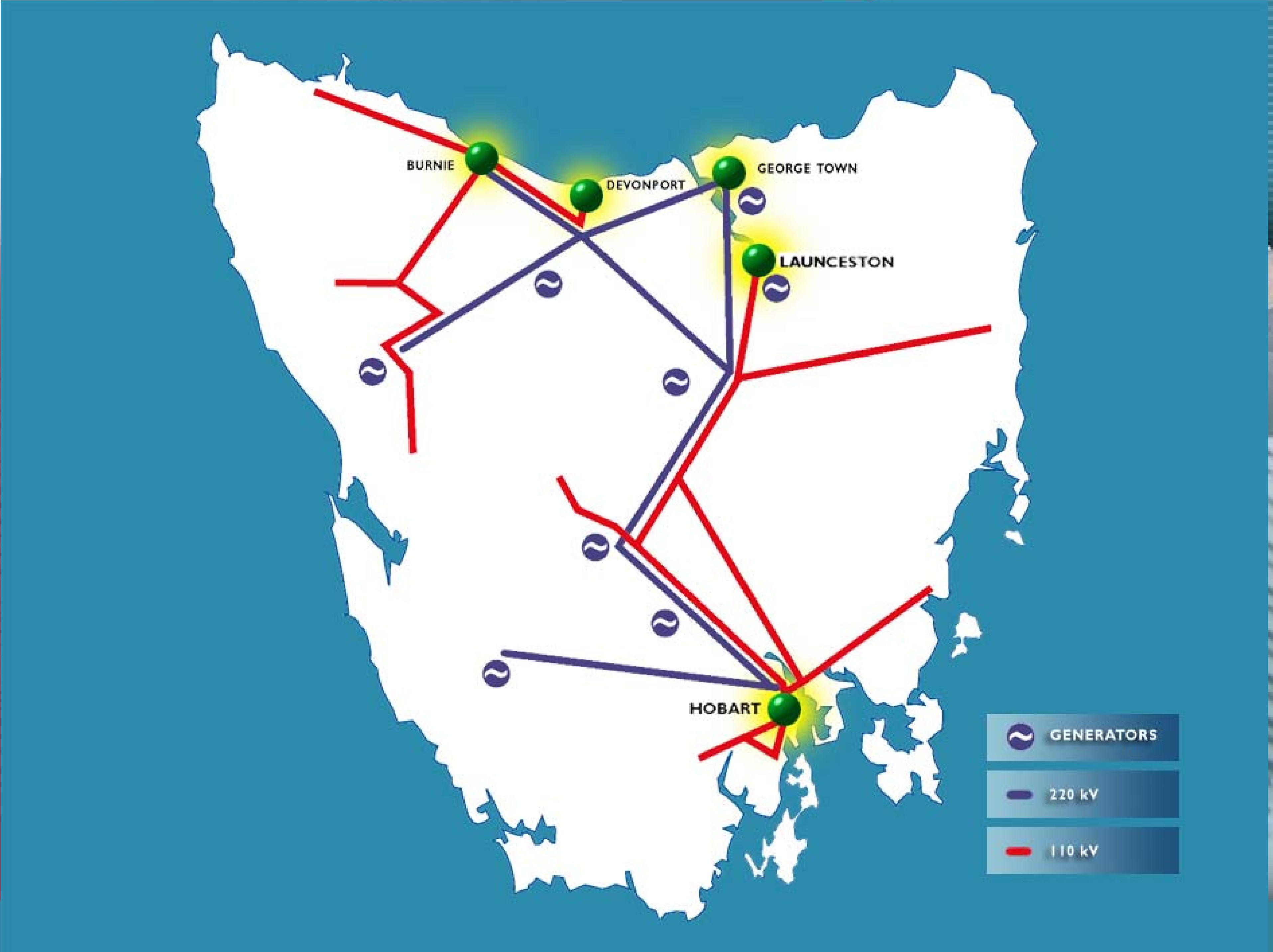
  - GHD recognised all these changes in their narrative
  - ACCC has gone part way in their Draft Determination

Myth: Substantial efficiency gains can be obtained

- Transend has already delivered efficiency improvements
  - Use of asset manager – service provider model
  - Use of competitive market prices
  - Use of condition-based maintenance
    - GHD: capex renewals program would be higher if age-based
  - World leader in use of dynamic ratings
    - Efficient operation of existing assets

- And Transend will continue to find ways of doing the right things better

- Incentive regulation: Any further efficiency gains should be shared between customers and shareholders


BURNIE
DEVONPORT
GEORGE TOWN
LAUNCESTON
HOBART
GENERATORS
220 kV
110 kV

Benchmarking should recognise differences between TNSPs

- Transend has arguably one of the most difficult Transmission networks in Australia
  - Long, stringy network
  - Large number of small, weather-dependent hydro power stations
    - Lower cost power source but more complex transmission
  - Aged asset base - poor condition, significant maintenance and augmentation
  - Relatively small customer base
  - Large number of non-firm connections
  - No security or reliability criteria established by jurisdiction
- Dis-economies of scale and operating conditions:
  - With the same level of efficiency, Transend's costs of operation should be high relative to the larger mainland TNSPs
  - ACCC's benchmarking indicates Transend opex is
    - highest on one measure
    - lowest on one measure
    - middle of the pack for others
- Given our circumstances, opex request is efficient

Consultation – doing it better

- Transend accepts that improvements in consultation could be achieved – and it is improving

  - ✓ More papers and information to the reliability and network planning panel
  - ✓ Presentations to customers about revenue cap application, pricing methodology
  - ✓ Regular dialogue with Aurora and generators about their future needs
  - ✓ Establishing generation and Aurora account managers
  - ✓ Improving the Annual planning review – increasing parties' involvement, published on web site

- Transend extended invitation to all parties to discuss any issues with our revenue application

Transend's concerns with the ACCC's Draft Decision

- ACCC's Draft Decision relies heavily on GHD's report
- GHD undertook a very detailed analysis of Transend's cost forecasts, however
  - Elements of GHD's conclusions were not supported with evidence
  - Inconsistency between GHD's analysis of operating and capital expenditure requirements and GHD's conclusions
  - Draft Decision compounds weaknesses by accepting GHD's conclusions without further supporting evidence
  - The ACCC is imposing a severe stretch target in terms of operating cost reductions
  - ACCC applies an arbitrary (10% - 25%?) cut to capital expenditure - and the rules aren't clear

Opex implications

The ACCC have allowed average opex which equals the 2002-03 actuals. This is equivalent to assuming:

ISSUE	IMPLIED ASSUMPTION
NEM entry, Basslink & NEC compliance	Does not occur and no additional cost implications
Wind generation	No wind generation proposals and no system impact
Future interface with NEMMCO	
Driving assets harder and replacement of obsolete technology	Not required and no impact on operating costs
Extra regulator (ACCC), new service standards regime	
Regulatory, community and market environments	Unchanged and no impact on costs

TRANSEND

Concluding comments

- Transend’s revenue application is not an ambit claim and there is no “fat” to cut
- Look again at the GHD report and the comments that Transend has made in response
- Concentrate on the facts – and recognise that the environment is changing
- Look to the future, don’t rely on the past: ensure that our collective needs will be met

Comments on the ACCC's "alternative capex approach"

Presented by: Isaac Katz
Director, Harding Katz Pty Ltd

17 October 2003

Overview of presentation

- Back to basics
  - How to design a robust regulatory framework?
  - What are the key questions to guide design?
  - How should the revenue cap regime work?
- GHD’s confusion
- ACCC’s alternative capex approach
- Wider design concerns - clawback on capex
- Concluding comments

Basic design issues (1)

Question 1: What should be regulated?

- Transmission services that are not contestable
- Where one party has significant market power
  - Otherwise, light-handed or no regulation

Question 2: What are the objectives of regulation?

- Outcomes must foster efficient investment

Question 3: Is there a mandated form of regulation

- Incentive-based revenue cap or some other variant

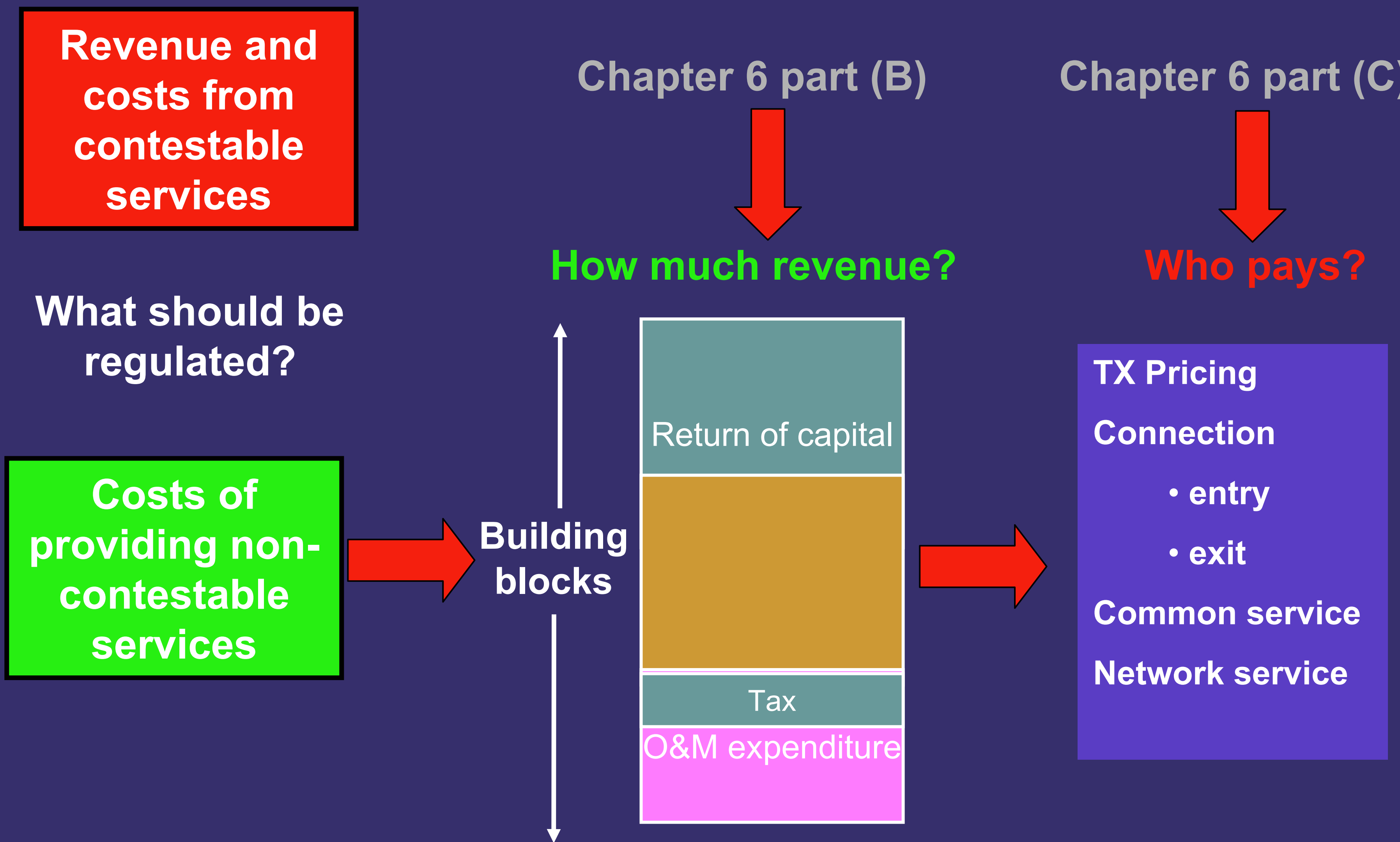
Question 4: What are the properties of the mandated form of regulation?

- Incentive to minimise opex and capex expenditure

Question 5: What additional controls/rules are needed to deliver the objectives?

- Services incentive scheme to ensure that service quality is not compromised

How does the revenue cap work?



GHD's methodological error

~~Revenue and costs from contestable services~~

What should be regulated?

~~Costs of providing non-contestable services~~

Excludes capex which benefits generators

Chapter 6 part (B)

How much revenue?

Building blocks

- Return of capital
- Return on capital
- Tax
- O&M expenditure

Chapter 6 part (C)

Who pays?

- TX Pricing
- Connection
  - entry
  - exit
- Common service
- Network service

ACCC's alternative capex approach

~~Revenue and costs from contestable services~~

Customer-specific assets

Chapter 6 part (B)

How much revenue?

Chapter 6 part (C)

Who pays?

~~Costs of providing non-contestable services~~

Shared network

Building blocks

Return of capital

Return on capital

Tax

O&M expenditure

TX Pricing

Connection

- entry
- exit

Common service

Network service

Concerns with the alternative capex approach

- Perpetuates GHD's confusion that the "who pays question" determines "what should be regulated"
- Question of market power between two parties should drive the decision to regulate
- Code is clear that contestable services should not be regulated
  - Therefore, contestable new connections could fall outside the revenue cap
  - Details of this arrangement need to be worked through
  - This approach could be accommodated without need for an "alternative approach"
- Problem and solution?
  - ACCC does not explain what problem the alternative capex approach is attempting to solve
- Wider concern that ACCC's approach to capex is not properly designed…

Design concerns

- Three pillars of capex regulation:
  - Revenue reset process
  - Regulatory test
  - Optimisation risk
  - NOTE: ESC has 1 pillar!
- Alternative capex proposal suggests that a 4th pillar should be added
  - Customers should determine whether costs are rolled into the asset base
- Unclear what incentive issues/problems this 4th pillar is intended to address
- Is the approach workable – has it been thought through?
- ACCC's approach to "clawback" – a much more serious problem

Clawback on capex?

- Draft decision states that a clawback on capex underspend will apply
  - Zero incentive to deliver capex efficiencies
  - Inconsistent with Code requirement for incentive-based regime which delivers efficient investment
- ACCC's discussion paper on dSoRP states that the Commission should choose an incentive mechanism with these characteristics (page 56):

  (1) The incentive mechanism *should lead to incentives for cost-reducing effort on both opex and capex which are constant over time*;

  (2) The incentive mechanism *should give rise to roughly equal incentives for cost reducing effort on operating expenditure and on capital (i.e., investment) expenditure*; and

  (3) Provided the incentive mechanism satisfies the two criteria above, is sustainable, and ensures adequate incentives for maintaining service quality the incentive mechanism *should yield the highest power of incentives for cost reduction*.

Radically inconsistent with a clawback on capex

Concluding comments

- Design of the regulatory framework needs to be considered with care:
  - What should be regulated; objectives, mandated revenue cap; incentive properties; problems and solutions
- GHD confused the question of "who should pay" with the issue of revenue setting
- ACCC's alternative capex approach starts from GHD's confusion
  - Has it identified a problem with the existing arrangements?
  - Does it present a workable and carefully considered solution?
- ACCC is developing contradictory views in relation to clawback
  - A clawback regime provides no incentive for efficiency gains
- Efforts should concentrate on developing a regime which delivers on the Code objectives to provide an incentive-based regime which delivers efficient investment