TRANSEND

Our Ref: 01/5605

20 October 2003

Mr Sebastian Roberts
General Manager
Regulatory Affairs - Electricity
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Dear Sebastian

Transend's revenue cap review – draft decision

As you are aware, the Commission published its Draft Decision on Transend's revenue cap on 24 September 2003. Transend met with Sabesh Shivasabesan and his team in Tasmania on Wednesday 15 October 2003 to discuss the Draft Decision. Following that discussion, I am writing to you directly on a number of specific concerns relating to:

1. Operating expenditure;
2. Capital expenditure;
3. Clawback; and
4. The Commission's alternative capex approach.

Details of Transend's concerns are outlined in the following attachment. I understand that Sabesh Shivasabesan has indicated that some of these concerns may be addressed in written responses directly to Transend, rather than in the Final Decision document.

There are also necessarily a number of important practical details that will need to be worked through and clarified as we approach the Final Decision. It is in the interests of all parties that the Final Decision provides clear guidance and avoids ambiguity. I understand that Sabesh Shivasabesan has agreed to work with Transend on the points

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of detail over the coming weeks. Transend welcomes a continuation of the open and co-operative approach that we have enjoyed thus far.

Transend will be making a formal submission in response to the ACCC's Draft Decision. However, given the important nature of the matters raised in this letter and attachment, I would welcome your response to the issues raised in the following attachment as soon as practicable. I should also like to meet with you again in early November to discuss these issues in person.

Yours sincerely

Richard Bevan
Chief Executive Officer

ATTACHMENT:

TRANSEND SPECIFIC CONCERNS WITH DRAFT DETERMINATION

1. Operating expenditure

Transend is very concerned that the Draft Decision relies on GHD's conclusions in relation to operating expenditure. In raising this concern, Transend notes that GHD's review of Transend's operating and capital expenditure involved all parties in very substantial effort and expense. It is therefore very worrying that the basis for GHD's conclusions amount to no more than 2 pages of trend analysis. GHD's conclusions bear little relation to the detailed narrative in their report, and there is no attempt to reconcile the difference.

GHD's 'trend' applies an unexplained 2% efficiency 'dividend' to the cuts already imposed on Transend's operating expenditure request. Incentive regulation should provide incentives for regulated companies to reveal their efficient costs - with any efficiency savings shared between investors and customers. By providing customers with a 2% efficiency 'dividend', Transend considers the Commission has strayed from the intent of incentive regulation.

Transend's submission on the GHD report, dated 23 July 2003, quantified the significant gap between GHD's narrative and its conclusions in relation to operating expenditure. In fact, even if Transend agreed with all of GHD's narrative and its proposed efficiency dividend of 2% per annum, this gap is still $12 million over the regulatory period. Not only is this $12 million reduction in operating expenditure unjustified and unsustainable, it is to date unexplained.

The National Electricity Code (clause 6.2.6) requires the ACCC to publish full and reasonable detail of the basis of and rationale for its decisions. In Transend's view, the Draft Decision does not properly consider the criticisms that Transend has made of the GHD report. In particular, the Draft Decision does not explain how the Commission has resolved the inconsistencies in the GHD report in reaching its view on operating expenditure. In the absence of this resolution or some other evidence or analysis, the Commission cannot reasonably rely on GHD's conclusions.

It is important that the Commission takes proper account of the points made by interested parties in reaching its decisions. As important, the Commission must be confident that Transend has sufficient revenue to meet the challenges in the next regulatory period. Transend reiterates that these challenges are very different to historic or current experience. Despite Transend's correspondence with Ed Willet at the commencement of GHD's review process, and his subsequent assurances, the Commission appears set on adopting a rudimentary approach to setting operating expenditure allowances.

The simplicity of the Commission's benchmarking approach in the Draft Decision, and its reliance on GHD's simple trend analysis, contrasts sharply with the reality of operating the transmission network in Tasmania to 2009 and beyond. Transend has provided GHD with over 100 documents, which support our revenue application. It is essential that the Commission gives due weight to this information by having regard to the narrative in the GHD report, as well as GHD's conclusions. Furthermore, it is essential that the Commission properly assesses the available evidence in a balanced way to deliver a sustainable operating expenditure allowance.

Transend seeks formal assurance that the Commission will properly address, if not resolve, the inconsistency between GHD's narrative and its conclusions. In doing so, the Commission would need to go well beyond the Draft Decision's unqualified reliance on GHD's conclusions. Transend also seeks assurance that the Commission will review the 2% efficiency 'dividend', and consider whether its application is consistent with incentive regulation: where shareholders and consumers are to share in any efficiency gains.

2. Capital expenditure

GHD's report mistakenly argued that any capital expenditure that will benefit generators should be excluded from the revenue cap. The exclusion of capital expenditure on this basis is inappropriate because the Code requires the revenue cap to apply to non-contestable services. Services are non-contestable if there is ineffective competition between services providers – the identity of the customer (generator or load) has little bearing on the degree of competition.

Nevertheless, as GHD's report excluded generator-related capital expenditure from the revenue cap (see page 45 of the GHD report) it follows that an alternative means of recovering these costs from generators must be provided. The Draft Decision fails to recognise this important point. The Draft Decision reduced GHD's allowance by a further 10%, but makes no provision for the recovery of generator-related capital expenditure. Specifically, the Draft Decision (page 48) states:

> The ACCC agrees with GHD that its capex allowance of $341m represents a maximum allowance and that it should be rationalised taking into account non-technical factors. The ACCC considers that an across-the-board reduction of 10 per cent on GHD's maximum allowance would balance the interests of Transend and its customers more appropriately.

The apparent intent of this statement is to apply a 10% reduction to GHD's capital expenditure figure of $341 million, which explicitly excludes generator-related capital expenditure. However, in his meeting with Transend staff, Sabesh Shivasabesan stated that the ACCC's capital expenditure allowance <u>includes</u> all generator-related capital expenditure. In effect, the Draft Decision requires Transend to finance all generator-related capital expenditure from the Commission's allowance of $307 million. Our calculations suggest that this amounts to a 21% reduction from GHD's implied allowance. On any reasonable interpretation, the Draft Decision proposes a 10% reduction, not anything more.

Transend is very concerned that the Commission should apply an arbitrary reduction to capital expenditure plans which GHD have confirmed to be technically justified.

There is no basis for a 10% reduction, let alone the 21% reduction actually applied according to Sabesh Shivasabesan's view. It is Transend's contention that the Code does not provide for the Commission to simply impose arbitrary decisions.

Furthermore, it should be noted that a substantial proportion of Transend's development capital expenditure projects have been subject to review by the Tasmanian Reliability Network Planning Panel (RNPP) in accordance with the regulatory test. It therefore seems appropriate for the Commission to provide for these projects in full, rather than to impose a 10% reduction. GHD's Final Report also considered that these projects should be allowed in full.

Transend seeks formal assurance that these errors in the Commission's assessment of capital expenditure are appropriately addressed. In asking for this assurance, Transend notes again that Transend and the Commission share a joint responsibility to make a balanced assessment of the transmission network's capital expenditure requirements to 2009. The efforts that Transend has made in developing its capital expenditure projections, and the detailed analysis conducted by GHD, should not be set aside in favour of an arbitrary and unexplained reduction.

3. Clawback

In Transend's discussion with Sabesh Shivasabesan, he explained that in his view any under-spend in capital expenditure will be returned to customers in the next regulatory period through a clawback arrangement. In Transend's view, clawback is inconsistent with 'an incentive-based regulatory regime' which is mandated by the Code. In effect, clawback provides no incentive to deliver efficiency improvements.

In sharp contrast to the statements in the Draft Decision, the Commission's recent discussion paper on the Statement of Regulatory Principles (see page 42) proposes an incentive regime which gives equal weight to capital and operating expenditure efficiencies. This proposition, which Transend would strongly support, is diametrically opposed to the concept of clawback on capital expenditure.

Of course, in part this discussion is somewhat academic as the Commission's Draft Decision provides no scope to better the benchmark allowances. Having said that, Transend is very concerned that in relation to such an important regulatory principle, the Commission's recent work is inconsistent, and most importantly the clawback proposal do not satisfy the Code requirements. The Final Decision will need to adopt a more robust and sustainable approach to this issue, in the light of the on-going discussions on the Statement of Regulatory Principles.

Transend further notes that, should the Commission maintain its approach to clawback as outlined in the Draft Decision, the Commission should remunerate any prudent capital *over*-expenditure, including within the past regulatory period. Transend expects the Final Decision to address the 2002-03 capital expenditure under-recoveries accordingly.

4. The Commission's alternative capex approach

Transend would like to raise some issues with the Commission's 'alternative capex approach', which is presented in appendix C of the Draft Decision. Transend supports any move towards light-handed regulation, and Transend believes that the Code does provide for such arrangements. However, Transend is very concerned that the detail of the Commission's 'alternative capex approach' has not been fully articulated or carefully thought through.

In Transend's view, developing new regulatory arrangements as part of a revenue cap decision is high-risk. It essentially amounts to revising the regulatory framework 'on the run', and is unlikely to consider or resolve all the relevant issues in an optimal way. The Commission should strenuously avoid adopting any approach now, which may later prove to be unworkable or impractical. For these reasons, Transend cannot accept the alternative capex approach as presented.

Transend reiterates, however, that Transend staff are ready to work with the Commission to improve the regulatory arrangements within the confines of the Code. There is ample opportunity to develop more light-handed regulatory arrangements, especially where new connections can be negotiated fairly between the proponent and Transend. These are matters to resolve and develop over the coming months.