Our Ref: 01/5605-2

23 July 2003

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

Dear Sebastian

GHD's report on Transend Networks' revenue cap application

I refer to the Commission's requests for comments on GHD's consultant report, which reviewed key aspects of the revenue cap application for Transend Networks (Transend). Transend is extremely disappointed with GHD's report and believes that many of its conclusions cannot be relied upon by the Commission.

In Transend's view, GHD has not fully understood many of the basics of regulated transmission or the particular circumstances in which Transend will operate during the regulatory period.

For example:

- GHD has not understood that connection assets do not need to pass the regulatory test, or the distinction between the revenue-setting and transmission pricing processes. These are basic regulatory matters that should be properly understood by the Commission's appointed experts.

- When benchmarked, GHD's recommendations place Transend in the same cost category as the large transmission companies serving states with largely thermal generation, where the cost of providing transmission is lower. Transend's operating environment is arguably the most difficult in Australia, serving a largely hydro-electric-based generation system. The Tasmanian system is required to have assets connected to generators in remote locations, often over very difficult terrain. These

assets are only used when particular generators are in service which, in turn, depends upon the availability of water in the catchments.

Despite these weaknesses in GHD's report, Transend is encouraged that the report contains numerous positive references to the need for, and the reasonableness of, Transend's claims for future operating and capital expenditure. In particular, GHD recognises the changing environment in which Transend must operate as Tasmania moves towards joining the National Electricity Market.

Notwithstanding these positive references, GHD's conclusions, in regard to both operating and capital expenditure, do not appear to follow their findings contained in their report.

In both cases GHD suggest that subjective assessments should be made, which would give completely different results to the earlier analysis. The bases of these subjective assessments are not documented. Such subjective assessments would not be acceptable to the Commission were they to be made by Transend in its revenue application. Transend believes that GHD's analysis should be held to the same high standards.

In the case of operating expenditure, GHD has said it has adopted an analysis based on the company's historical costs drawn from the year 2001-02. This may be appropriate where the chosen year is a reasonable measure of Transend's likely future business operations. This is not the case with Transend as GHD's research shows. It is now widely acknowledged that, with the benefit of hindsight, Transend's present revenue determination is short of the mark. For example, the company spent $3 million in excess of its determination in the year to 30 June 2003.

The GHD recommendations, based on the 2001-02 figures, result in operating expenditure forecasts that are $24 million lower than the level implied by GHD's earlier analysis, and more than $35 million below Transend's own expenditure forecasts.

Reductions in operating expenditure of this magnitude are simply unachievable. Transend cannot waive its obligations to its transmission customers and stakeholders, and nor should it. It is imperative that the transmission system is placed on a sound financial footing that recognises the important challenges ahead. GHD's conclusions with respect to Transend's expenditure requirements will not achieve this important outcome.

The attached response sets out the principal matters where Transend takes issue with GHD's report. The response demonstrates that the Commission cannot rely upon many of GHD's conclusions. In addition, Transend intends to provide further detailed comments on the numerous inaccurate and misleading statements made by GHD throughout its report.

Transend's response indicates our continued focus on discussing and explaining the relevant issues with our stakeholders and the Commission. In this regard, Transend

reiterates its open invitation to interested parties to discuss their concerns or issues with our project director, Stephen Clark, and his team. Interested parties can arrange mutually convenient meetings with Stephen by calling him on 03 6278 6126.

Yours sincerely

[original by mail]

Richard Bevan
Chief Executive Officer

Encl.

Transend's revenue cap review – response to GHD's report

The Australian Competition and Consumer Commission (the Commission) appointed GHD to review the operating and capital expenditure forecasts presented by Transend in its revenue application. GHD's final report was published on the Commission's webpage on 1 July 2003. This submission is Transend's response to the issues and conclusions presented in GHD's report.

1. Operating Expenditure

Transend is extremely concerned that GHD's report concludes that $35 million can be removed from Transend's operating expenditure forecast over the regulatory period. This is equivalent to one year's total operating expenditure budget in the next regulatory period. In Transend's view, this level of reduction in operating expenditure is unattainable without compromising service levels.

It is somewhat difficult for Transend to respond to the GHD Final Report on operating expenditure as it consists of two distinct parts. It is even more difficult as the conclusions arising from these two parts are inconsistent.

The first part consisting of 15 pages (pp. 59-73) is a detailed analysis of Transend's operating expenditure forecasts based on several months of analysis, including requests for additional material from Transend and extensive discussions.

Transend agrees with most of this detailed analysis in this first part, although there are some relatively minor concerns with GHD's proposed approach to capitalisation. Transend would have expected that GHD's positive conclusions from this detailed analysis would be carried through to its recommended operating expenditure forecasts. Unfortunately this is not the case.

The second part, referred to as an 'alternative opex trend analysis' consists of only three pages (pages 74-76), including only 1.5 pages of explanation. One of the three pages is a table (Table 7-8) that is extremely difficult to understand. Many of the figures in this table are inconsistent with the conclusions from the detailed analysis in the first part.

The report does not contain any sound analysis to support the recommendations for opex that are included in the second part of the opex chapter. There is minimal justification for the approach adopted and no analysis of the implications of these reductions for Transend's levels of service.

This is disappointing for Transend as

- the extensive work undertaken to develop operating expenditure forecasts

- the additional information provided to GHD
- extensive discussions with representatives of GHD over a period of some months and
- the detailed GHD analysis in the first part of the chapter

have been dismissed in a mere three pages.

It is particularly galling for Transend as GHD has criticised Transend's opex forecast for lacking sophistication. In addition, GHD has criticised Transend for making 'no clear evaluation of the consequences of undertaking an alternative course of action.'

GHD have ignored risk in their analysis while requiring Transend to develop its consideration of 'risk-based cost and service levels.'

1.1 Summary of the GHD reductions

The GHD reductions from the detailed analysis include:

- reductions for Basslink ($4.39 million)
- reductions for opex to capex ($6.2 million)
- reductions for depreciation ($0.65 million).

These reductions total $11.2 million.

GHD explain the reasons for these reductions as follows:

> 'NEM entry and participation costs. These costs have been allowed in full excluding costs forecast for entry and participation into Basslink amounting to $4.39m. Such costs are considered recoverable from Basslink Pty. Ltd…' (GHD final report, page 74)
>
> 'GHD is of the opinion that Transend has incorrectly applied the Capitalisation Policy to the treatment of Transformer Overhaul, and Post Insulator Upgrades.' (GHD final report, page 66)
>
> 'An adjustment to the total Transmission Operations costs is required due to an inadvertent error of including depreciation by Transend.' (GHD final report, page 68)

GHD's detailed analysis does not justify any other explicit cost reductions. However, the total reductions proposed by GHD over the regulatory period are $35.2 million (GHD Table 7-7).

Therefore, there is a $24 million gap between the reductions identified in GHD's detailed analysis ($11.2 million) and GHD's conclusions using the 'alternative opex trend review' ($35.2 million). These figures are summarised in Table 1.

Table 1: Comparison of GHD's opex analysis and GHD's conclusions (2002/03 $m)[1]

	Jan to Jun 04	04-05	05-06	06-07	07-08	08-09	Total
Transend's total application	**16.0**	**33.4**	**36.5**	**36.9**	**35.0**	**35.2**	**193.0**
GHD's reductions using 'analysis'	**0.8**	**2.5**	**2.3**	**1.9**	**1.9**	**1.9**	**11.2**
GHD's reductions using 'opex trend'	**2.9**	**3.6**	**5.6**	**7.2**	**7.8**	**8.1**	**35.2**
GHD's opex 'analysis' forecast	**15.2**	**31.0**	**34.2**	**35.0**	**33.1**	**33.3**	**181.8**
GHD's conclusion	**13.1**	**29.8**	**30.9**	**29.7**	**27.2**	**27.1**	**157.8**

Transend has identified two reasons which partly explain the difference between GHD's opex 'analysis' forecast and GHD's conclusions.

Firstly, GHD's proposed operating expenditure forecast disregards Transend's equity raising costs of $3.3 million (see Table 7.9 of Transend's application, page 84). The Commission is expected to consider these costs in the same manner as it has done in previous revenue decisions. Therefore, to compare like with like, $3.3 million needs to be added to GHD's conclusions.

Secondly, GHD's conclusions include $8.7 million of cumulative efficiency gains (GHD Table 7-8). Efficiency gains are discussed further in section 1.2.

The inclusion of these two explanatory factors (the equity raising costs and efficiency gains) narrows the gap between GHD's opex 'analysis' forecast and GHD's conclusions, but it does not eliminate it. Transend calculates that the gap is reduced from $24 million to $12 million.

1.2 Efficiency gains

Transend considers that GHD's approach to efficiency gains is inappropriate, as GHD's alternative 'opex trend' review:

1. presumes that efficiency gains have not already been factored into Transend's operating expenditure forecasts
2. applies a 2% cumulative efficiency factor to the 2001-02 'base level' of operating expenditure.

These concerns are discussed in turn.

1.2.1 GHD presume efficiency gains have not already been factored into Transend's forecasts

Transend has informed GHD on several occasions the reasons why the level of quantitative analysis expected by GHD in terms of quantifiable future operating expenditure efficiencies is not available. In essence, Transend's expenditure plans have been developed on an efficient basis by:

[1] Note that 2003-04 data is only in respect of the 6 months from January 2004 to 30 June 2004.

- ensuring that synergies between the operating and capital programs are captured and reflected in the expenditure forecasts
- anticipating improvements to existing practices, including: extended maintenance periods for certain assets and increased grouping of work on a bay basis
- continuing use of dynamic ratings, which maximise the use of existing assets
- providing no allowance for likely increases in input costs
- capturing cost savings as a result of the transfer of planning functions from the System Controller to Connections and Development
- making no allowance for operating expenditure increases as a result of Transend's significant future development capital expenditure.[2]

The inclusion of these efficiencies in Transend's forecasts does not depend on their separate quantification as GHD suggest - the efficiencies are attained through a demonstrably efficient planning process.

Transend has explained to GHD that there is a risk in many areas that the company has understated the likely future scope and cost of its activities. In recognising this, Transend has committed itself to seeking additional future efficiency gains.

Therefore GHD applying a further 2% cumulative efficiency gain, in addition to those already factored into Transend's forecasts, is inappropriate.

1.2.2 GHD apply the cumulative efficiency factor to the 2001-02 "base level" of operating expenditure

In the case of operating expenditure, GHD has said it has adopted an analysis based on the company's historical costs drawn from the year 2001-02.

This may be appropriate where the chosen year is a reasonable measure of Transend's likely future business operations. This is not the case with Transend as GHD's research shows. It is now widely acknowledged that, with the benefit of hindsight, Transend's present revenue determination is short of the mark. For example, the company spent $3 million in excess of its determination in the year to 30 June 2003.

GHD's alternative 'opex trend' review therefore applies an efficiency factor to an inappropriately low base.

GHD do not provide any justification for their proposed 2% annual efficiency gain from 2001-02 levels either by reference to Transend's operations or by reference to the Commission's revenue cap decisions in respect of other TNSPs. Transend notes that

[2] The exception is that opex costs associated with operation of the System Protection Scheme and for Basslink commissioning are included in the opex forecasts. GHD considers these costs are more appropriately recovered from Basslink Pty Ltd. Transend included these costs in its regulatory opex forecast as it considers that underlying asset (i.e.the SPS) is not providing a contestable service.

efficiency factors have not been included in any of the Commission's TNSP revenue cap decisions.

The 2% cumulative efficiency factor has the effect that in 2008-09 Transend is required to achieve efficiencies of 10 % compared with 2001-02. This cannot be achieved without compromising service levels.

Transend is experiencing a period of rapid change, which will continue over the forthcoming regulatory period. In Transend's view, the GHD-recommended $8.7 million of efficiency improvement - in addition to the efficiencies already factored into Transend's opex forecast - is not attainable over the forthcoming regulatory period.

1.3 Other concerns

In addition to the unexplained gap between GHD's analysis and its conclusions, Transend also has some detailed concerns. These relate to capitalisation policy and GHD's suggested approach to insurance.

In relation to capitalisation policy, GHD has concluded that Transend has inappropriately treated Transformer Overhauls and Post Insulator Upgrades as operating expenditure. Transend maintains that this expenditure should be treated as operating expenditure because the expenditure does not improve the performance, capacity or useful life of the asset.

In relation to insurance, GHD conclude that insurance costs should not be passed through, and instead an allowance of $950k per annum should be included as an operating cost item. Transend believes that its suggested approach is consistent with the Commission's recent decisions with regard to other TNSPs revenue caps.

Setting aside the issue of the appropriate regulatory approach, GHD's proposal to include $950k per annum as an operating cost allowance for insurance is inadequate. This is because treating insurance costs as an operating cost item requires an allowance to be made for insurance premiums, the expected costs of deductibles and the expected costs of uninsured events. GHD has suggested that only an allowance in respect of the premium is required and have ignored the other aspects of Transend's proposed insurance framework (see page 82 and Schedule 1, Appendix 1 of Transend's revenue cap application).

In addition, despite GHD's claim that the insurance market is stable, Transend is advised by its insurers that premiums will exceed $950k for the forthcoming year. This advice reinforces Transend's view that the pass-through of insurance costs (including premiums, deductibles and uninsured events) is the most appropriate regulatory approach.

1.4 Way forward

In summary, Transend is extremely disappointed that GHD's conclusions adopt an alternative 'opex trend' review to reduce Transend's operating expenditure by over $35 million in total. Overall, GHD's conclusions regarding operating expenditure are not fully justified and cannot be attained by a prudent TNSP. In Transend's view, GHD's conclusions regarding operating expenditure cannot be relied upon by the Commission in its decision.

Transend considers that, to account for the deficiencies identified by Transend in GHD's opex recommendations, the Commission has two options:

1. reject the GHD recommendations and undertake a new opex review based on Transend's revenue cap application and the information provided to GHD.
2. re-do the alternative 'opex trend' analysis in a rigorous way, explaining any deviations from the revenue claim sought by Transend.

Transend is happy to work with the Commission to pursue either option.

2. Benchmarking

GHD's report acknowledges the analysis undertaken by Benchmark Economics which explains that benchmarking on the basis of partial indicators is fraught with difficulty. In particular, benchmark analysis should consider economies of scale and the special features of a hydro-based transmission system. Benchmark Economics' report explains that, once due account is made for the supply-side capacity necessary in a hydro-based transmission system, Transend is a very low cost performer. In fact, Transend's application recognises that its existing cost base is unsustainably low[3].

It is disappointing, therefore, that although GHD acknowledge the issues raised by Benchmark Economics, GHD's benchmarking analysis and conclusions rely on simplistic partial indicator benchmarks. These benchmarks fail to consider economies of scale or the nature of the Tasmanian transmission system, and therefore distort Transend's relative performance.

More importantly, the benchmarks presented do not consider the impact of GHD's conclusions with regard to operating expenditure. If GHD had applied even these simplistic benchmarks to its own conclusions, GHD may have realised that its operating expenditure conclusions are unsustainable. To illustrate this point, we have reproduced GHD's benchmarks to include GHD's conclusions on operating expenditure. In addition, we also include a comparison of TNSPs' operating expenditure per substation, which shows Transend to be the lowest cost performer. GHD omitted to provide this diagram in its report although it was made available by Transend.

[3] It should be noted that Benchmark Economics analysis clearly shows that Transend's costs were below other TNSPs in 2001-02. However it is these 2001-02 costs that are used by GHD as the basis for their "opex trend" review.

Figure 1: Comparison of TNSPs' operating expenditure as a percentage of assets

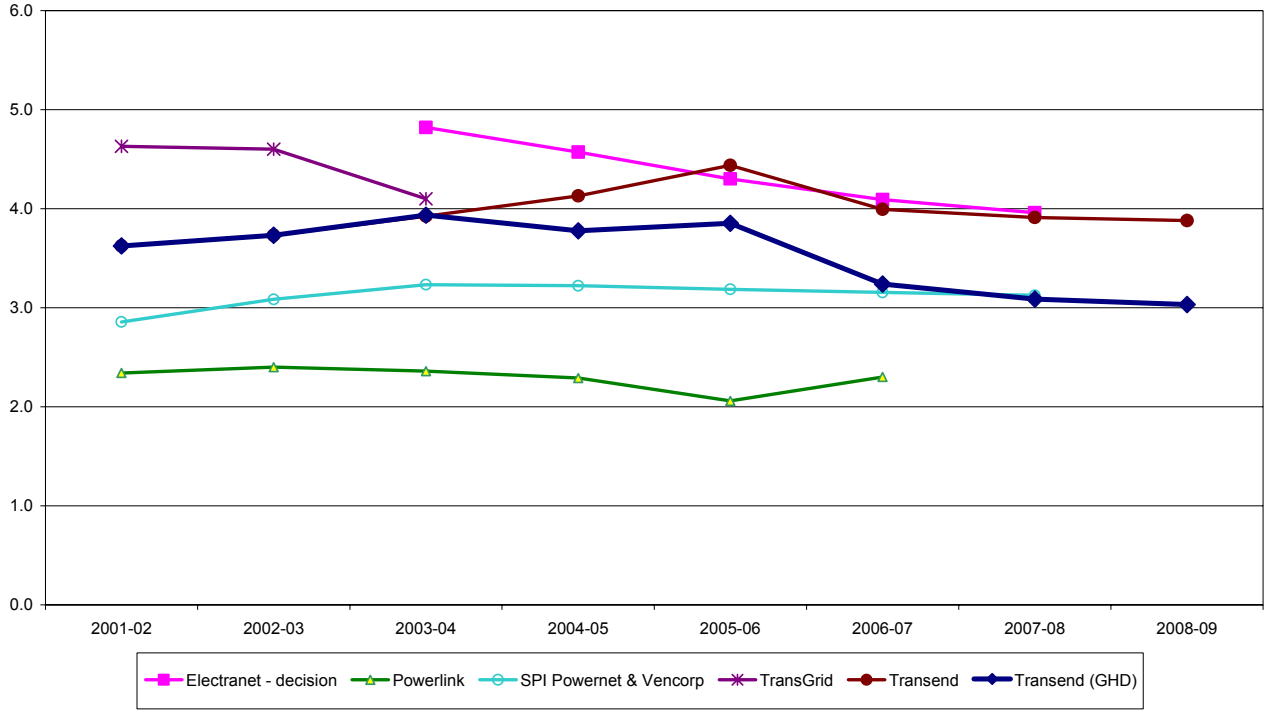


Figure 2: Comparison of TNSPs' operating expenditure ($'000) per line length

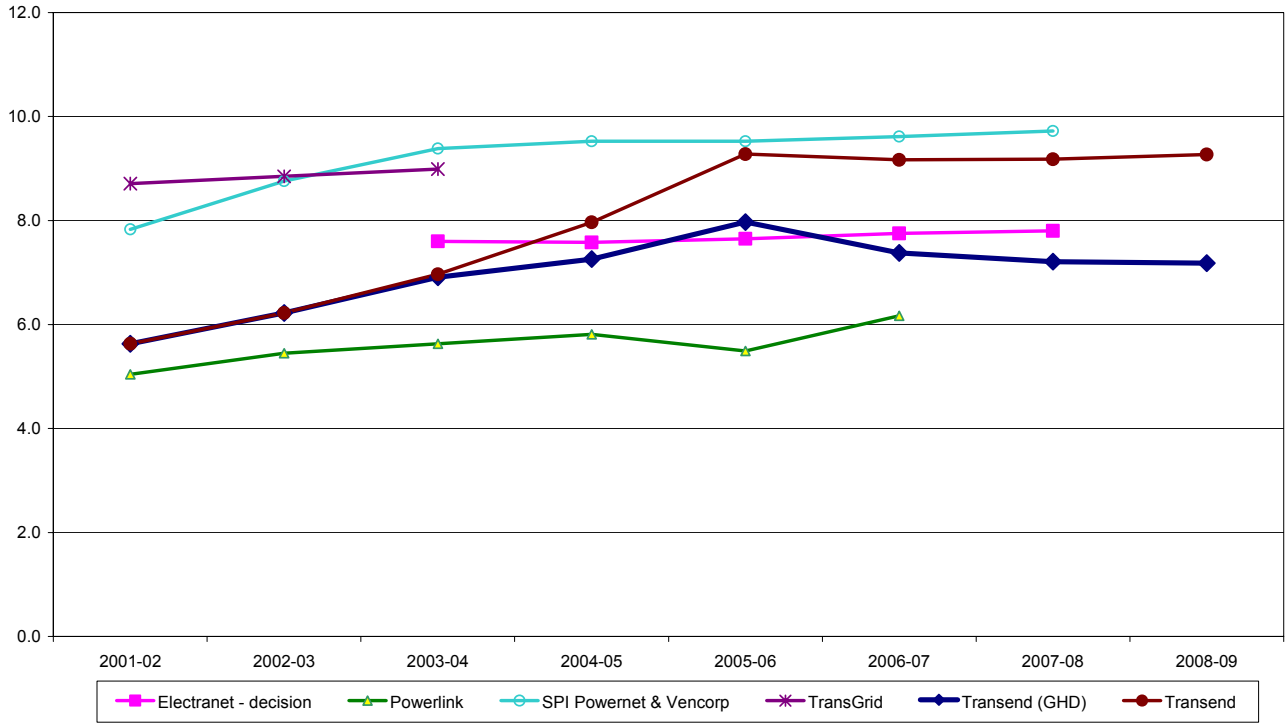


Figure 3: Comparison of TNSPs' operating expenditure ($'000) per substation

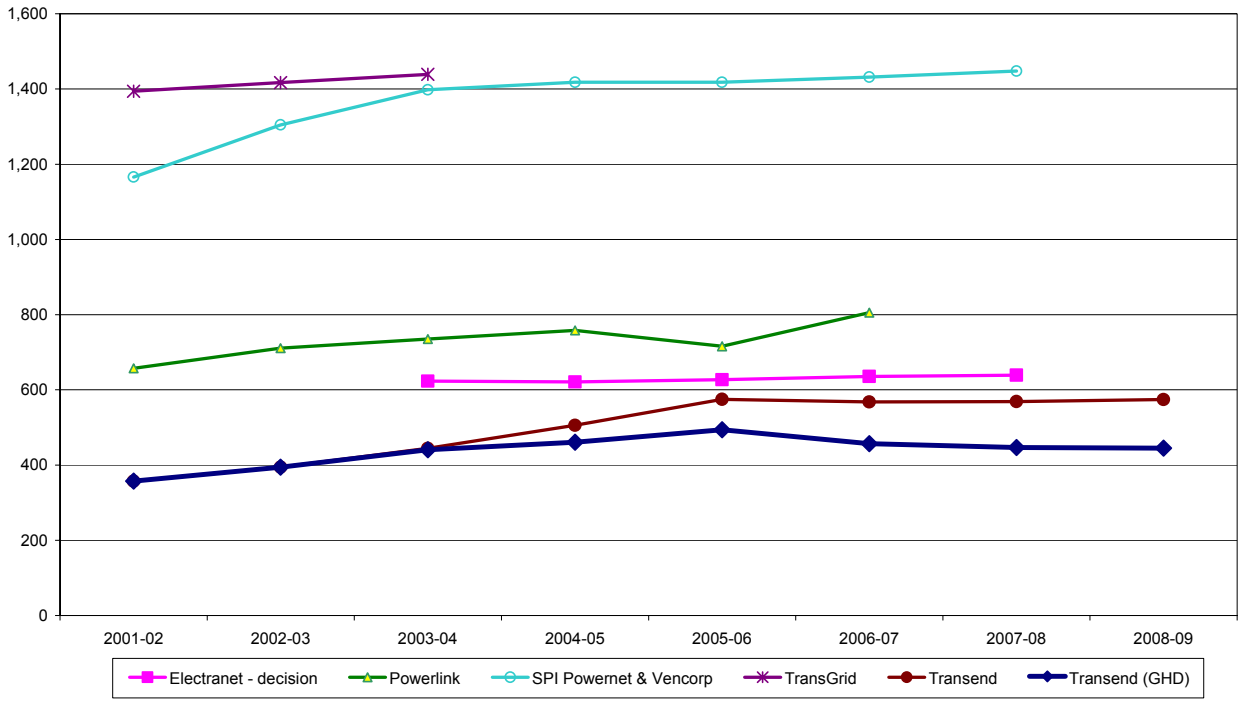


Figure 4: Comparison of TNSPs' operating expenditure ($'000) per MW capacity

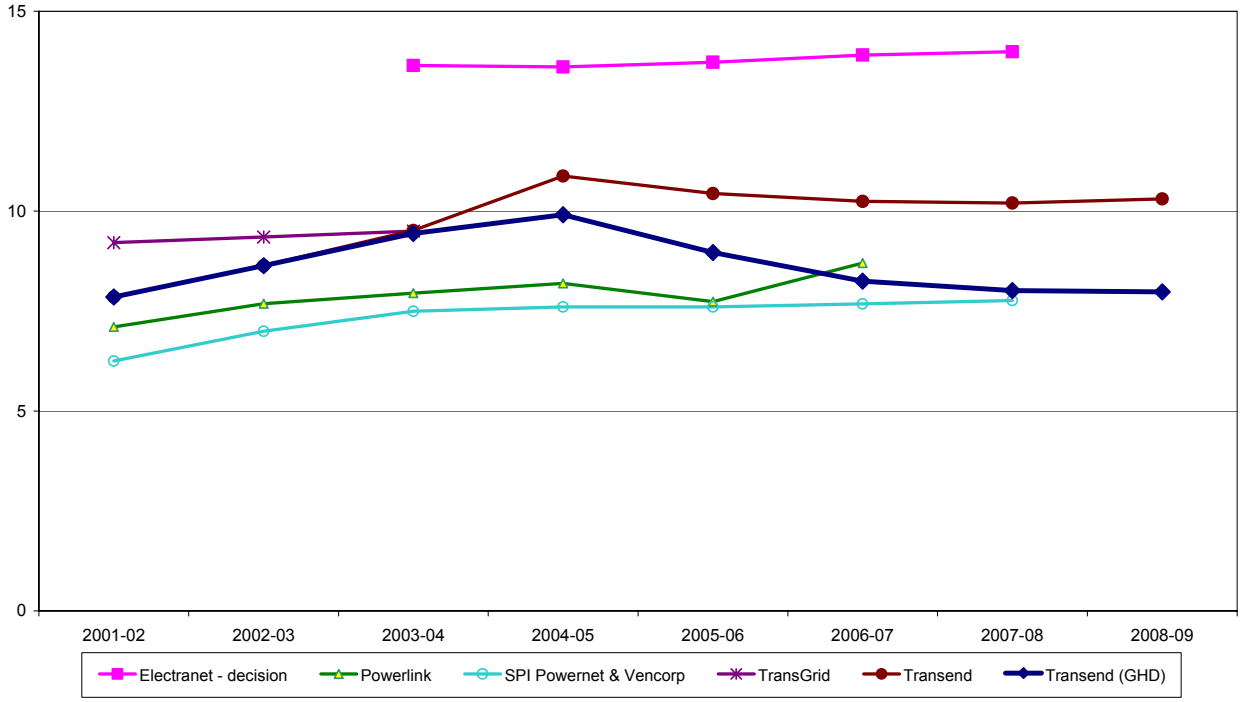


Figure 5: Comparison of TNSPs' operating expenditure ($'000) per MW peak demand

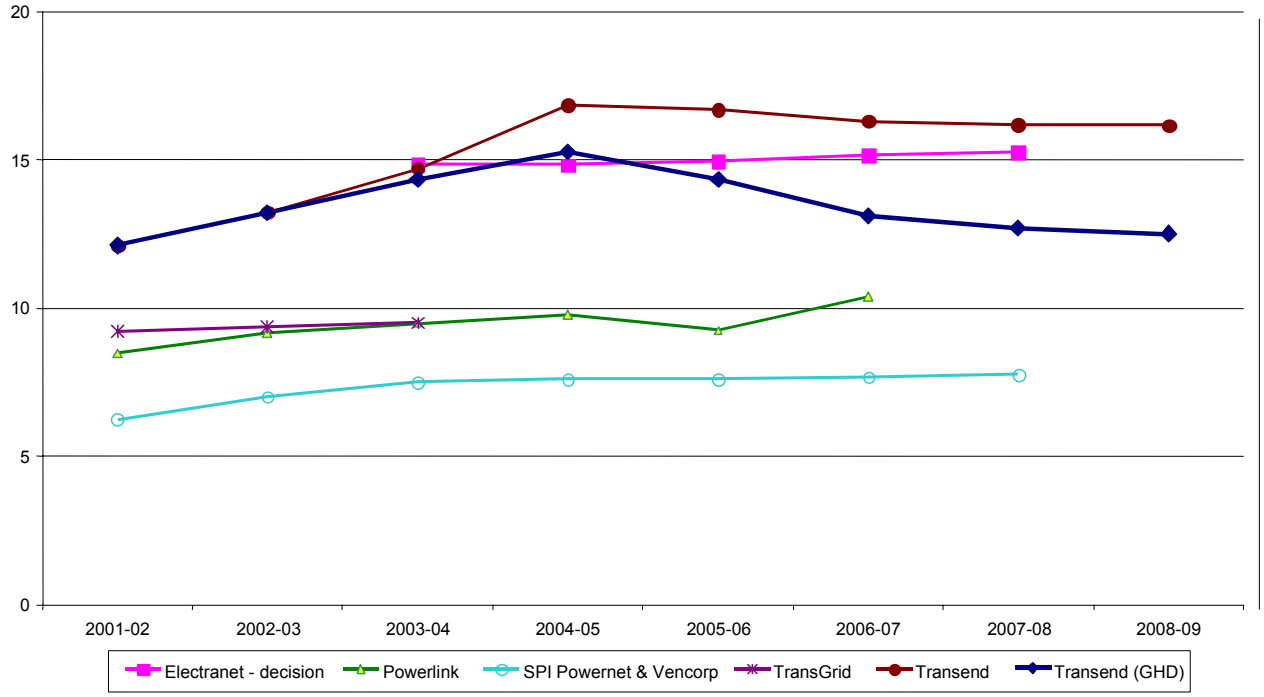
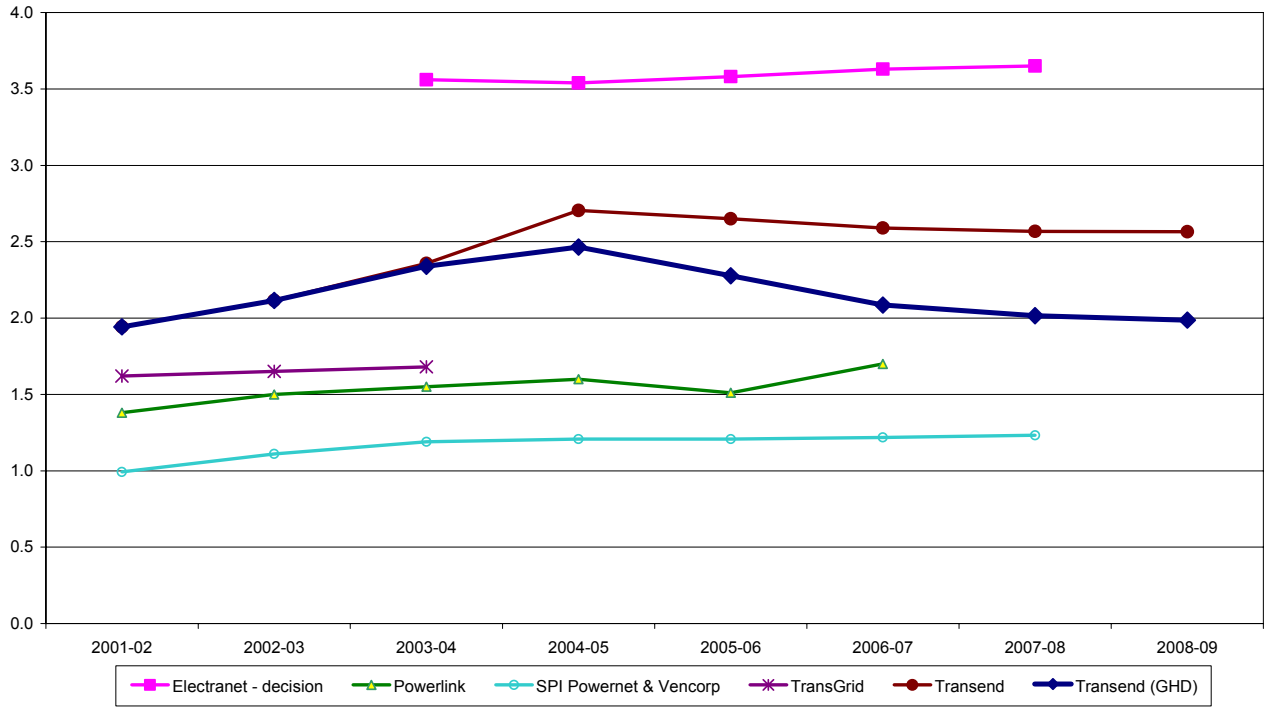


Figure 6: Comparison of TNSPs' operating expenditure ($'000) per GWh



These benchmarks show that GHD's conclusions on operating expenditure would result in Transend's cost base being one of the lowest for the majority of the partial indicators and generally below ElectraNet for all six indicators. In fact, GHD's recommendations show Transend with costs comparable to the Victorian transmission costs (SPI PowerNet & VENCorp). Such an outcome is not credible given the differences in the transmission systems and their respective sizes.

In any event, Transend reiterates its concern that this type of benchmarking approach is simplistic in that it assumes that there are no economies of scale in electricity transmission. Such an assumption is incorrect and invalidates the comparisons between TNSPs' costs. Moreover, the transmission system in Tasmania is hydro-based which makes supply capacity more appropriate than peak demand as a cost driver. Transend urges the Commission to re-examine Benchmark Economics' report in considering its draft decision.

3. Capital Expenditure

GHD's final report is generally positive about Transend's capital program for the forthcoming regulatory period. The capex review predominantly contains sound analysis of Transend's capital forecasts and the drivers underpinning these forecasts. However, the analysis and recommendations are adversely affected by some GHD mistakes and misunderstandings relating to:

- Transend's use of security and planning criteria and the impact of these criteria on the capital forecast
- GHD's non-inclusion and/or delay to some fixed capital projects
- GHD's non-inclusion of many variable capital projects:
    - GHD have excluded all generation-related assets
    - GHD have excluded all projects relating to high load growth
    - GHD have applied outdated probabilities for the variable projects.

Despite these mistakes and misunderstandings, the most disappointing aspect of GHD's analysis of capex is that, after acknowledging the robustness of Transend's capital program, the recommendation is for a 'subjective' cut to the capital allowance.

These issues are discussed in more detail below.

3.1 Security and planning criteria

GHD make many misleading comments with respect to the security and planning criteria, including the following:

> 'The overall magnitude of the impact of [Transend's security and planning] criteria on the capital expenditure is not possible to define until some agreement on the criteria to be applied is reached.' (GHD final report, page V)

> 'In assessing the renewal expenditure it is not clear to GHD as to which renewals are being driven by the reliability criteria on which Transend has based its capital expenditure program.' (GHD final report, page 51)

GHD appear not to have understood that the security and planning criteria were developed for forecasting augmentations to the network (i.e.development capex) as part of Transend's revenue cap application. The criteria were not used for renewals forecasting, nor are the criteria binding. Transend has explained this to GHD on a number of occasions.

The security and planning criteria are criteria which Transend considers could apply as part of the regulatory test. This issue is explained in chapter 6 of Transend's revenue cap application.

As GHD notes on page 55, the only projects whose inclusion in the forecasts is based on the security and planning criteria are

- George Town 220kV and
- Sheffield security augmentations.

GHD concludes that these projects are justified on technical grounds (see page 43). Therefore, GHD's 'summary of findings' (pages 55 - 57) is particularly unhelpful as it suggests that the security and planning criteria have a far greater impact on the capital forecast than GHD elsewhere acknowledges as being the case.

3.2 Project delays and omissions

3.2.1 Fixed development projects

GHD has delayed the timing of the George Town and Sheffield projects (see pages 43-44) whilst commenting, 'it is not clear as to what effects will occur if these projects are delayed'. Transend considers this to be an unusual application of the 'cost-risk trade-off' and 'budget rationalisation involving customers' processes advocated by GHD. In comparison, Transend's timing for these projects has been determined with respect to the development capex drivers, including Code compliance. Transend therefore considers that GHD's deferral of capital expenditure is not soundly based.

3.2.2 Renewal projects

GHD has omitted a further $3 million in 110kV circuit breaker replacements, and notes that:

> 'GHD has adjusted the capital expenditure for these to occur after the RP on the expectation that condition-based assessment will extend the asset lives beyond the nominal age given to them by Transend.' (GHD final report, page 54)

Therefore, while GHD consider that condition assessment may make it possible to delay renewal of these assets to the next regulatory period, they have not noted the converse: that condition assessment may indicate that the replacement of these assets must be brought forward. By excluding this expenditure from the capex allowance altogether, GHD is implying that the outcome of condition assessment is a foregone conclusion. If this were the case, Transend would not waste its resources undertaking such assessment.

3.3 Variable development projects

GHD has not made an assessment of Transend's innovative proposal for the treatment of uncertain capital expenditure, by allowing different treatments for 'fixed' and 'variable' capex. There appears to be no discussion of the merits or otherwise of such an approach, but rather an assumption that there is sufficient information provided to make the preliminary estimates 'appropriate for a weighted probability of occurrence costing approach.'

GHD state that:

> 'The Commission has directed GHD to establish a reasonable level of Capex for the [variable] projects, considering their probably [sic] of occurrence, and on the basis of meeting the regulatory test' (GHD final report, page 45)

Transend is disappointed that the ACCC have directed GHD to take this approach, which potentially disadvantages Transend's customers.

Setting aside this issue for the moment, Transend has a number of concerns about GHD's approach to variable capex:

1. GHD have excluded all generation-related assets
2. GHD have excluded all projects relating to high load growth
3. GHD have applied outdated probabilities for the variable projects.

Transend addresses these concerns in turn.

3.3.1 GHD have excluded all generation-related assets

GHD state that:

> 'There are a number of the projects related to generation connection including wind, hydro, gas, wood-to-waste energy etc. It is not clear as to the determination of benefits of the regulated (shared) assets, which are proposed for augmentation only because of the generation development. However, on the basis that these projects will deliver specific benefits to individual companies it appears unlikely that they would pass a regulatory test. During review, GHD noted that some projects in the Application provide for both new generator connections and demand growth, and include costs for the connection assets in the Transend substations. The generators are allocated costs for the transmission line to the substation but do not appear to be allocated costs for the new connection asset in the substation.
>
> Where appropriate, these connection costs have been excluded by GHD, on the basis that this component at least would be unlikely to pass a regulatory test. It is recognized that the assets will be owned and maintained by Transend and will be subject to regulation.' (GHD final report, page 45)

These paragraphs contain a number of mistakes and omissions, which are outlined below:

- failure to address the issue of what assets should properly be regulated
- mistaken understanding of the grounds for passing the regulatory test
- confusion between inclusion in the regulatory asset base and payment for assets
- confusion as to whether connection assets must pass the regulatory test.

Figure 7 below is a simplified flowchart outlining the steps to determine what assets should be included in the capex forecast used to set the revenue cap.

Figure 7: Determining the capex forecast for the regulated asset base (RAB) and settting prices

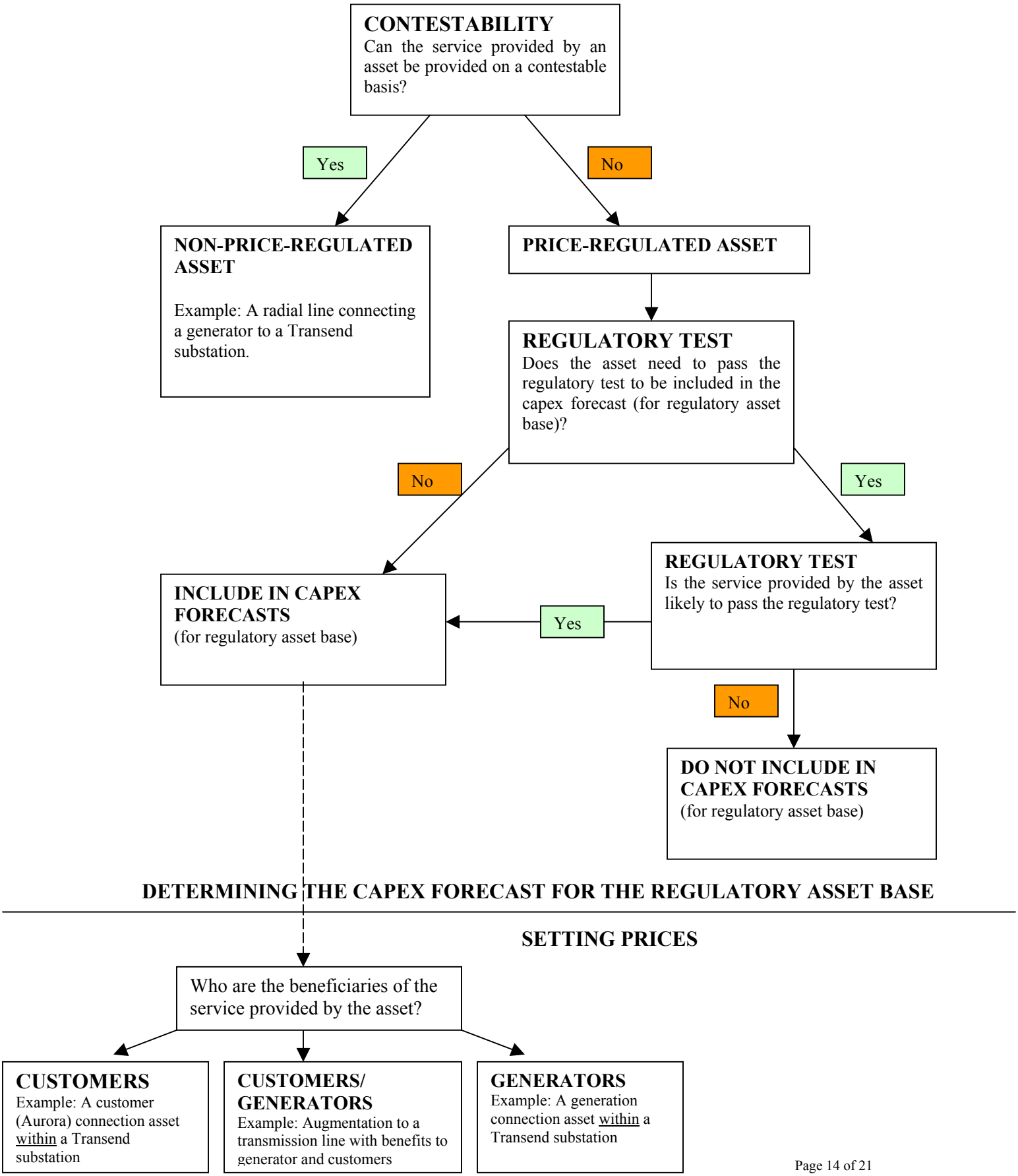


Figure 7 shows that there is a three step process that GHD should follow:

1. What assets should be regulated?
2. Does the regulatory test apply?
3. If the regulatory test applies, is the proposed investment likely to satisfy the test?

In relation to the first step, if an asset provides a non-contestable service, that service should be regulated. The augmentations to Transend's shared network cannot be provided on a contestable basis. These assets should therefore be regulated assets, whether or not the need for the investment is caused by new generation developments.

In relation to the second step, only large network developments are subject to the regulatory test. In accordance with the Commission's regulatory framework, connection assets and renewal investment are not subject to the regulatory test.

In relation to the third step, GHD appear to have concluded that if the principal beneficiary from a 'shared network' augmentation is a generator, then this would mean that a project would not pass a regulatory test:

> 'on the basis that these projects will deliver specific benefits to individual companies it appears unlikely that they would pass a regulatory test.' (GHD final report, page 45)

GHD is confusing two different steps:

1. Should an asset be part of the regulatory asset base?
2. Once an asset is included in the regulatory asset base, who are the beneficiaries that should pay for that asset (i.e. how does Transend recovers its revenue entitlement by levying charges on different customer groups and generators) ?

By looking at the second step, rather than the first, GHD appears to have mistakenly decided that all generation-driven projects will not pass the regulatory test. In fact connection assets are not even subject to the regulatory test.

In summary, Transend is concerned that GHD have misunderstood the regulatory arrangements. As a result, its rationale for excluding particular categories of capital expenditure is not soundly based.

3.3.2 GHD have excluded all projects relating to high load growth

In the months of June and July 2003 Transend experienced record peak winter loads placed upon the network. Key nodes in the transmission system have been placed under extreme pressure, reinforcing the need for development projects.

A new system peak of 1,690 MW was set on 4 July 2003. GHD forecast that Tasmania would reach this level of winter peak demand by 2008, rather than 2003. This suggests that GHD's forecasts may understate Tasmanian load growth and particularly growth in peak demand.

Transend does not consider that there are any grounds for excluding projects on the basis that they are driven by high load growth.

3.3.3 GHD have applied outdated probabilities for the variable projects

Transend's application was predicated on pass-through of actual costs for variable projects. The ACCC appear to have directed GHD to make a probabilistic assessment of the variable projects, to arrive at a total 'fixed' capital figure.

GHD have relied upon SKM's probabilistic analysis for variable projects, completed in September 2002. GHD did not request updated probability information. Since September 2002 there has been progress on a number of the projects, which has changed the probability of some projects proceeding. As the ACCC appear to be pursuing a probabilistic approach to capex, rather than a 'fixed' and 'variable' approach, Transend has reviewed the probabilities included in SKM's (and GHD's) report.

Transend's updated internal assessment of the probabilities of each of the variable projects proceeding in the forthcoming regulatory period is listed in Table 2 below:

Table 2: Transend's revised probabilities of variable projects proceeding

Variable Project	GHD recommend-ation	Probab-ility old	Transend recommend-ation	Probab-ility new	Transend comments
Aurora Connections					
Southwood wood processing	include	0.8	include – higher probability	0.9	Aurora advises that customer is well advanced and equipment for sawmill ordered.
Wynyard area upgrade	include	0.3	include - higher probability	0.4	Aurora advises of future industrial development proposals and feeder reliability issues.
Hadspen transformer augmentation	include	0.8	include – higher probability	0.9	Aurora advises of issues with high load in Launceston area – urgent need to offload Norwood by transfer to Hadspen.
Additional Aurora feeders	include	0.48	include – higher probability	0.8	Aurora considers that 75% to 80% of additional feeders certain, others dependent on further studies.
Mt Nelson Substation	exclude	0.12	exclude	0	Aurora advises Sandy Bay and Kingston feeder work should extend beyond 5 years.
Lindisfarne transformer augmentation	exclude	0.12	include– higher probability	0.5	Aurora advises that existing load growth, combined with potential load increase due to Geilston Bay and Bellerive work in 2005-06, increase probability.

Variable Project	GHD recommend-ation	Probab-ility old	Transend recommend-ation	Probab-ility new	Transend comments
Generation Connection Assets					
Tarraleah 220kV Connection Stage 1	exclude	0.8	include– higher probability	0.9	Current negotiation with Hydro is for capability of 4 x m/c on 220kV via single circuit 220kV to Liapootah (i.e.Stage 1).
Tarraleah 220kV Connection Stage 2	exclude	0.48	include – lower probability	0.1	
Woolnorth Wind – Stage 2	exclude	0.8	include– higher probability	1.0	Connection Agreement for stage 2 nearly finalised.
Robbins Island/ Jim's Plains	exclude	0.1	Include – higher probability	0.2	Development application advertised for Robbins Island. Connection application received for Jim's Plains.
Musselroe	exclude	0.8	include	0.8	Four months before environmental approvals known – still considered high probability of proceeding.
Heemskirk	exclude	0.32	include	0.32	Hydro position is that Heemskirk is strong on their agenda.
Brighton Waste	exclude	0.48	include	0.48	Project has been given council approvals but still facing public opposition.
George Town Waste	exclude	0.32	include	0.32	No change.
Bell Bay 350 MW connection	exclude	0.32	include	0.32	No change.
Southern gas fired power (GFP) station	exclude	0.32	include – lower probability	0.1	Probability of GFP obtaining sufficient market share for viability seems doubtful.
Shared network augmentations					
Farrell to George Town 220kV	exclude	0.4	include	0.4	If Heemskirk progresses and greater that 150MW west cost wind then need for this project in regulatory period.
Burnie to Smithton 110kV Upgrade (Woolnorth Stage 3)	exclude	0.8	include	0.8	Current thinking is additional 110kV line rather than upgrade existing circuits. Hydro have indicated intent to develop Woolnorth Stage 3 and lodged Connection Application.
Smithton to Sheffield 220kV Line	exclude	0.1	include	0.1	Likely to proceed if Robbins Island wind development proceeds.
North east line upgrade (Musselroe Wind)	exclude	0.8	include	0.8	Linked to Musselroe connection assets (see comments above)
Reactive Support George Town 30MVAr	exclude	0.1	include	0.1	No change.
Reactive Support George Town 70MVAr	include	0.4	include	0.4	No change.

If the ACCC decide to adopt a probability-weighted approach to variable development capital projects, then the updated assessment of probabilities should be used.

3.4 'Subjective' assessment

GHD's report is on the whole very positive in terms of recognising the soundness of Transend's capital program. However, the final paragraph of GHD's analysis of capital expenditure undermines the previous analysis:

> 'Transend has not followed an appropriate practice of cost-risk trade-off or budget rationalisation process involving its customers, nor have the reliability impacts of any project been quantified. This means that the Capex rationalisation process must be undertaken on a subjective basis as part of the Commission's decision.' (GHD final report, page 56)

This statement is inaccurate and is largely inconsistent with statements made in early sections of the report, which express the view that the proposed level of capital expenditure is justified. Transend does not accept that a subjective 'rationalisation' of its capital expenditure plan is appropriate. Furthermore, we reject the assertion that a more detailed 'cost-risk' assessment would necessarily lead to lower levels of expenditure. Transend's view is that a more detailed assessment is likely to further justify the urgent need for the identified level of capital expenditure.

Following an extensive and lengthy review by GHD, Transend is very concerned that the conclusion is that a subjective (or arbitrary) reduction in capital expenditure is justified. Such an approach is not in the interests of Transend, its customers, or prospective investors in network infrastructure. It is essential that the Commission's advisors present a reasoned view of appropriate expenditure levels, supported by soundly based evidence. GHD's capex conclusion falls considerably short of this standard.

4. Regulatory Asset Base Roll Forward

4.1 Acquisition costs

Table 8-1 'Tasmanian State Treasurer's determination of the Transend asset base as at 30 June 2001 (in nominal $m)' of GHD's report incorrectly allocates $51.4 million in acquisition costs for substations and transmission lines to the 'land and easements' category, rather than to the underlying assets.[4]

Of this $51.4 million, $35.8 million should be allocated to transmission lines, for the acquisition costs of Transend's transmission line routes, and $15.6 million should be allocated to substation assets, for the acquisition costs associated with substation sites. Acquisition (or transaction) costs associated with creating a transmission line or substation include those associated with:

- site/route selection process and survey of site/route
- regulatory, planning and environmental approvals

[4] This allocation error flows from information provided by Transend, which grouped these assets for depreciation purposes.

- easement compensation and land purchase negotiations, including legal fees.

In Transend's revenue cap application, the value for easements has also been included in the total costs for transmission lines and cables. The easement value is $11.5m, which represents indexed historical easement compensation payments.

GHD's Table 8-1 should therefore have the total allocated to land and easements reduced by $51.4 million and the totals for substations and transmission lines increased by $15.6 million and $35.8 million respectively.

> 'The inclusion of an amount for acquisition costs based on estimates is not consistent with previous Commission decisions, as usual practice is to allocate these costs to the Capex project eg for transmission line costs…' (GHD final report, page 79)

Transend believes that this statement is incorrect. In particular, page 46 of the ACCC's draft determination on SPI PowerNet's revenue application states:

> **'**The transmission line replacement costs used for valuation purposes can be expected to include all planning and other costs associated with identifying and securing the line route. This would include all acquisition costs such as the costs of landowner negotiations, environmental impact and cultural heritage reports as required. The Commission considers that there would be no reason why transaction costs could not be charged against the replacement cost of the line.' (emphasis added).

In its final SPI PowerNet decision, on page 52 the ACCC reinforced this treatment, stating,

> 'In regard to the easement purchase management costs, the Commission notes that SPI PowerNet has sought and received opinion from SKM on how historically utilities treated the aforementioned costs. However, the Commission has not received from SPI PowerNet any evidence in the form of past records [relating to historic asset valuations] to justify this rationale. Hence the Commission maintains that these costs would be charged against the transmission line costs.' (emphasis added).

SKM's valuation of Transend's assets deliberately followed the ACCC's treatment of acquisition costs, and included all planning and other costs associated with identifying and securing the line route (and substation site), as part of the cost of the underlying assets. Meritec reviewed this approach, and ensured these costs were not valued above their deprival value.

In other words, the acquisition costs are essentially costs of providing the transmission line or substation, and the treatment presented by SKM and reviewed by Meritec is consistent with the ACCC's approach.

4.2 Refurbishment capital

With respect to refurbishment capital expenditure, GHD comment:

> 'Transend has treated Refurbishments after 1 July 2003 separately and applied a class life of 15 years as noted in Appendix 3 of the Application…The commission may wish to consider these issues.' (GHD final report, page 84)

The ACCC has already considered this issue. Transend revised its capitalisation policy to reflect the ACCC's SPI PowerNet and ElectraNet decisions: where a new 'category' of refurbishment capital was created. In these decisions, the ACCC allowed depreciation of refurbishment capital over a 10-year period.

Transend has applied the new capitalisation policy from the next full financial year after the ACCC's decisions were made. i.e. commencing on 1 July 2003.

5. Service Standards

GHD's final report made the following conclusion with regard to service standards:

> 'In the absence of further information, GHD concludes that the [Transend] proposed PI Scheme does not appear to be challenging when compared with past performance, albeit limited.' (GHD final report, page 87)

In preparing their service standard scheme, the Commission and SKM recognised the need for analysis of each TNSP's past performance. Transend's presentation of performance information in figures 5.2 to 5.5 and figures A1 to A4 of its application indicates that the targets proposed by Transend would be revenue neutral if past performance were to be repeated. To receive a material bonus, Transend will need to deliver substantial improvements over past performance. To be rewarded for an improvement in performance does not seem to us to be unreasonable, and it is understood that this is what the scheme is aiming to achieve.

GHD has reviewed the impact of Transend's scheme and notes that a nominal bonus would be paid to Transend if average past performance were repeated. Transend has not been able to replicate GHD's analysis. Transend's calculations show that its proposed scheme is effectively revenue neutral, but notes that GHD have not advised whether their proposal is revenue neutral.

GHD suggest some changes to Transend's proposed performance incentive scheme. There is no discussion as to why GHD believes that its suggested scheme addresses shortcomings in Transend's proposal. In fact, there is no explanation or rationale provided by GHD in support of its scheme.

6. Efficiency bonus

Chapter 3 of Transend's revenue application explains the basis for the inclusion of an efficiency bonus. In effect, Transend delivered efficiencies in the last regulatory period by delivering more 'output' than estimated by the Tasmanian Energy Regulator when setting the revenue control. This increased 'output' is in terms of scope increases that were not anticipated at the time of the previous revenue review.

The Commission has adopted a form of glide path regulation that rewards past efficiency improvements. This is a backward-looking concept in that it only considers the efficiency gains delivered in the previous regulatory period, and does not consider the prospect for future efficiency gains. This is the Commission's approach and is not something developed by Transend.

Transend has explained that in its view the Commission should recognise that efficiencies can be achieved in one of two ways (or as a combination):

- Delivering the same output for less cost; or
- Delivering an increased output for the same cost.

It is important, therefore, when assessing efficiency gains to consider both cost changes and output changes. For example, simply rewarding lower cost would not be desirable if output had also been reduced. In this regard, Transend's application explained that it had delivered a substantially increased output at a slightly increased cost. On this basis, Transend believes that an efficiency bonus is appropriate.

It is therefore disappointing that GHD's consideration of these issues amounts to less than half of one page. In this analysis, GHD confuse the consideration of the efficiency bonus with the consideration of future costs (which are not relevant to this issue):

> 'GHD has provided a suggested Opex trend which includes allowances for new tasks undertaken by Transend. It appears unnecessary to compensate Transend further for preventing incurred costs which should properly be claimed under the previous revenue period, if indeed they are justified.
>
> 'The basis on which an efficiency bonus is payable in addition to claimed Opex is thus difficult to assess.
>
> 'Consequently, GHD cannot recommend the allowance of an efficiency bonus.' (GHD Final Report, page 89)

As GHD has demonstrably misunderstood the purpose and rationale for the efficiency bonus, the Commission should attach no weight to GHD's conclusion on this issue.

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