Our Ref: 01/5605

24 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

Please find attached Transend's submission on the Commission's *Draft Decision: Tasmanian Transmission Network Revenue Cap 2004-2008/09.* Transend's submission is in two parts. The first is a summary of the critical issues Transend has identified in the Draft Decision. The second is a table, containing detailed comments on the Draft Decision text.

Transend's principle recommendations for the Commission are summarised below.

1: If the Commission is to apply a 10% reduction to GHD's 'unrationalised' capital expenditure allowance, then this should be applied correctly so that the proposed reduction is $24.5 million rather than $34.1 million.

2: To be consistent with GHD's report, the Commission should either

a) allow an additional amount for generator-related capital expenditure within the revenue cap

OR

b) provide for the recovery of generator-related projects outside the revenue cap.

3: The Commission should ensure that the Final Decision adopts a more robust and sustainable approach to the clawback issue, having regard to the Commission's recent statements in the discussion paper on the Draft Statement of Regulatory Principles.

4: The Commission should allow the 2002-03 capital expenditure under-recovery, as this is consistent with the intent of government policy.

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5: Following the Final Decision, the Commission should undertake to establish a framework to determine those activities that should be revenue-capped and those activities that can be subject to 'more light-handed' forms of regulation. The Commission should provide guidelines as to how 'more light-handed regulation' may be applied in practice. The Final Decision should be sufficiently flexible to allow these guidelines to be implemented without systematically disadvantaging Transend or Transend's customers.

6: The Commission should explicitly examine whether there is a gap between GHD's narrative and its 'alternative trend', and suggest a pragmatic way in which the gap may be shared between customers and Transend.

7: The Commission should remove the cumulative 2% operating expenditure efficiency 'dividend' as its application is inconsistent with previous Commission decisions and with incentive regulation.

8: The Commission should adopt an approach to assessing the WACC that is consistent with the principles articulated by the Productivity Commission. Specifically, the Commission should:

   a) adopt an equity beta value of 1.12

   b) adopt an MRP value of 7%, in light of the empirical evidence

   c) apply the 10 year bond rate as the risk free rate

   d) apply a benchmark credit rating of BBB+, and determine the debt premium accordingly

   e) determine the 10 day average period independently of the date of the Final Decision.

9: The Commission should accept Transend's definitions for the purposes of service standard reporting, until alternative definitions are agreed.

10: The Commission should base Transend's performance incentive scheme on a financial year, with reporting commencing from the 2003-04 financial year.

Transend requests that the Commission address each recommendation in their Final Decision. If you have any questions about the information contained in this submission, please contact Stephen Clark on 03 6278 6126.

Yours sincerely

Richard Bevan
Chief Executive Officer

Transend submission on the Commission's Draft Decision – Critical issues

1. Introduction

Transend welcomes some aspects of the Commission's Draft Decision on its revenue requirement for the period January 2004 to June 2009. In particular, the Commission has recognised that there are important changes to Transend's operating environment, which means that the next regulatory period will present a significant break from the past. Transend's revenue cap application, and its subsequent submissions, have consistently argued that relying on historic cost analysis or simple benchmarks is not appropriate where operating conditions are changing so markedly. To some extent, this important message has been reflected in the Draft Decision.

However, Transend remains concerned that the Commission has followed its consultants, GHD, in focusing unduly on minimising short-term price impacts, rather than determining an efficient level of operating expenditure. As noted by one speaker at the Commission's public forum on Friday 17 October:

> Society's true interest does not involve the lowest possible electricity rate. The public's interest lies in completely reliable electricity produced at reasonable prices. There is a difference. (Robert Samuelson, Washington Post)

Transend has devoted an enormous amount of time and effort to put forward an objective revenue application. The proposed increase in additional revenue has been treated by some as an ambit revenue claim. However, these assertions have not been substantiated by any analysis of the facts at hand. The Commission is required by the Code to present its reasons for its decision, and it is incumbent on the Commission to ensure that these reasons are properly based on fact.

The reasons for Transend's proposed increase in revenue has been fully documented in the Company's revenue application, and further supported through the provision of additional information requested by GHD. These reasons are:

- a starting asset base that was inappropriately low
- a starting operating expenditure base that was inappropriately low
- past regulatory and resource issues which hampered delivery of some capital programs
- large increase in activities since 1 July 1998
- change in cost recovery mechanism for system control after NEM entry
- future scope changes, including NEM entry, wind generation and introduction of gas
- an aged network in poor condition, requiring increased maintenance, renewal and augmentation.

Transend accepts that the Commission should not simply rely on Transend's assessment of these factors in reaching its Draft Decision. Transend co-operated fully with the Commission's appointed consultants, whose task was to provide an independent review of Transend's revenue requirements. The complexity of the matters raised can only be resolved with expert advice. It is not possible or credible to determine Transend's future revenue requirement on the basis of simplistic comparisons with companies who operate very different networks in contrasting terrains and with diverse load and generation characteristics.

Against this background, Transend does not believe that the Draft Decision presents sound reasons for the proposed reductions from the company's revenue application:

- The Commission has criticised Transend, stating that Transend did not provide significant information with respect to some aspects of its revenue request. This is despite a detailed application document, a supplementary submission and an extensive amount of information provided to the Commission and its consultants.

- The Commission has cut over $10 million per annum from Transend's revenue request, without any objective evidence. Discussions with the Commission's staff have not revealed any objective basis for the proposed reductions.

Unless the Commission revisits its Draft Decision, Transend's ability to provide Tasmanian customers with a reliable power supply will be severely hampered. This submission therefore focuses on the following areas:

- Capital expenditure
- Operating expenditure
- WACC
- Asset valuation
- Service standards

Transend's submission is in two parts. This is the first part, which provides a summary of the critical issues Transend has identified in the Draft Decision. The second part is a table, containing detailed comments of the Draft Decision text.

2. Capital expenditure

Transend has three principal concerns with the Commission's capital expenditure allowance:

- The Commission has mistakenly reduced the capital allowance for projects that have already passed the regulatory test
- The Commission has applied an arbitrary cut of 21% to GHD's recommended allowance
- The Commission has advocated clawback, which is contrary to incentive regulation.

2.1 Regulatory Test

The Commission's capital allowance applies an arbitrary 10% reduction 'across-the-board' to the capital allowance recommended by GHD as 'technically supported but unrationalised'. However, GHD noted that their capex allowance of $341m:

> should be considered a maximum, except for development projects which have passed the regulatory test. (page 56, GHD Final Report).

The Draft Decision mistakenly applies a 10 % reduction across-the-board. Table 1 shows that there are $95.85 million in capex projects that have already passed the regulatory test. There is no basis for imposing a reduction of 10% or any other amount to these projects. The Commission therefore appears to have mistakenly reduced Transend's capex allowance by $9.6 million.

Table 1: Fixed development projects ($ million 2002-03)

Total Fixed Development projects allowed by GHD	**109.2**
Fixed Development projects, yet to pass regulatory test	
Reactive support	6.8
Georgetown 220 kV rearrangement	3.5
Sheffield rearrangement	3.0
Total yet to pass regulatory test	**(13.3)**
Amount to which GHD note that capex reductions should not be made	**95.9**

The Commission should reinstate the $9.6 million in capex inappropriately cut from capital projects that have already passed the regulatory test.

Recommendation 1: If the Commission is to apply a 10% reduction to GHD's 'unrationalised' capital expenditure allowance, then this should be applied correctly so that the proposed reduction is $24.5 million rather than $34.1 million.

2.2 Arbitrary cut

The Commission notes,

> 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. (page 48)

This is a misleading statement, as the Commission has not applied a 10% reduction, but has applied a 21% reduction.

GHD's recommended \$341 million allowance had already excluded a large proportion of projects which Transend treated as variable – these excluded projects have a probability-weighted cost of \$47.1 million[1]. Of this \$47.1 million in variable capex excluded by GHD:

- \$1.2 million was for customer-related variable projects (Lindisfarne and Mt Nelson substation work), which was excluded on the basis that they would only proceed under a high load forecast scenario.
- the remaining \$45.9 million was for generation-related connection assets and shared network assets.

The Commission paraphrases GHD's comments as follows:

> GHD notes that Transend's variable capex proposal contains several projects relating to generation connection including wind, hydro, gas and wood-to-waste energy. It considers that the benefits of these projects are unclear. And as they deliver specific benefits to individual companies they are unlikely to pass a regulatory test. Hence GHD removed the expenditure for generation connection. (page 35)

Transend disputed the basis for GHD excluding these projects, as it confuses 'who should pay?' with 'what should be regulated?' As the Draft Decision states that the Commission intends to apply a 10% cut to the GHD recommendation, it follows that the proposed capital expenditure allowance of \$307 million must also exclude generation-related capital expenditure. This interpretation is also supported by figure 4.1 in the Draft Decision which compares Transend's capex request, GHD's recommendation and Commission's Draft Decision.

The Commission's staff have subsequently advised Transend that the capital expenditure allowance of \$307 million is to include any generator and generator-driven shared network augmentations. The effect of the inclusion of generator-related capital expenditure in the \$307 million allowance is to impose a much more significant reduction than 10% to GHD's recommended capital expenditure allowance.

[1] Based on SKM's 2002 analysis

To illustrate the impact, it is necessary to add back the generation-related projects to GHD's 'technically supported but unrationalised' capital expenditure allowance. This revised GHD allowance is then presented on the same basis as the Commission's allowance in the Draft Decision. The calculation to determine the actual reduction imposed by the Commission is as follows:

- GHD recommended $340.9 million in respect of customer-related capital expenditure (including a $6.2 million re-allocation from operating expenditure)

- GHD excluded $45.9 million on the basis that this should be paid by generators

- therefore, GHD's total 'unrationalised' capex was $340.9 million + $45.9 million = **$386.8 million.**

The Commission has imposed a 10% cut to the recommended $340.9 million customer-related expenditure, giving a total of $306.8 million. However, the inclusion of generator-related capital expenditure in the Commission's total means that the Commission's reduction is:

- $386.8 million (GHD's implied allowance) - $306.8 million (Draft Decision) = $80 million.

This is a 21% reduction from GHD's capital expenditure allowance, not 10% as noted in the Draft Decision.

Appendix 1 provides the detailed information to support this statement. In Transend's view, the Draft Decision is intended to apply a 10% reduction, not a 21% reduction to GHD's 'unrationalised' but technically justified capital expenditure allowance. An arbitrary cut of 21% is necessarily even more difficult to justify than the intended 10%. Transend also notes that the Commission makes the following unsubstantiated claim in respect of its proposed capital expenditure allowance:

> …based on Transend's application, GHD's findings, interested parties submissions and its own analysis, the Commission considers that a capex program of around $307m over the regulatory period is sufficient for Transend to meet its obligations under both the code and TEC. (page 49)

<u>Transend cannot observe any Commission analysis in the Draft Decision that would support this very strong conclusion.</u>

Transend does not consider that the other components of the capital allowance (for renewals, non-generator driven augmentations, and non-network capex) can be reduced further to accommodate new generation proposals. Transend will therefore need to reach capital funding arrangements with new generation proponents so that delivery of Transend's other capital work is not affected.

The company urges the Commission to reassess its work in relation to capital expenditure and to make the necessary steps to address material errors in the Draft Decision.

Recommendation 2: To be consistent with GHD's report, the Commission should either

a) allow an additional amount for generator-related capital expenditure within the revenue cap

OR

b) provide for the recovery of generator-related projects outside the revenue cap.

2.3 Claw back

The Draft Decision appears to suggest that a clawback arrangement will apply in respect of capital expenditure. Under this arrangement, any under-spend in capital expenditure compared to the Commission's benchmark will be returned to customers in the next regulatory period through lower charges. In our 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 on clawback, 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.

It is noteworthy that the Commission is practically alone amongst regulators in considering the imposition of clawback. The Office of the Regulator General (the Essential Services Commission's predecessor) in Victoria commented as follows in relation to its 2001 Electricity Distribution Price Review:

> To ensure that the regulatory framework provides incentives for the distributors to operate efficiently, the Office concluded early in its price review consultation process that it would be desirable for the distributors to be rewarded for some of their within-period efficiency gains through into the next regulatory period. The principal benefit of such a reward is that by clarifying and strengthening the incentive for distributors to increase their efficiency, the price customers pay for electricity distribution services over the medium term will be lower than otherwise would be the case.
>
> Chapter 6 sets out in detail the incentive scheme the Office intends to apply in assessing and rewarding efficiency gains at the 2006 Price Review. The main feature of this scheme is that distributors are rewarded when their out-turn operating or capital expenditure in any year is less than the benchmark established for that year at the previous review. The design of the scheme ensures that the incentive to make operating and capital expenditures savings is neutral between the two. The incentive to make savings is also equal between one year and another, with the full benefit of any operating or capital expenditure savings being retained by a distributor for five further years, whether those gains are achieved at the beginning or end of a regulatory period. By clarifying its future approach now, the Office is confident that both shareholders and customers will benefit from the distributors' enhanced focus on operating and capital cost efficiency. (Pages 14 and 15 of ORG 2001 EDPR Draft Decision).

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.

Recommendation 3: The Commission should ensure that the Final Decision adopts a more robust and sustainable approach to the clawback issue, having regard to the Commission's recent statements in the discussion paper on the Draft Statement of Regulatory Principles.

2.4 Capital under-recovery

The Commission has not allowed Transend's request for capital under-recovery in 2003. Reducing Transend's capital allowance was an unintended consequence of the price determination extension. It was not a government policy decision to disallow this expenditure, as the Commission appears to believe.

Further, to be consistent with the Commission's approach to clawback in the Draft Decision, the Commission should remunerate any prudent capital *over*-expenditure within the past regulatory period. The Final Decision should therefore include the 2002-03 capital expenditure under-recovery. This will also be consistent with the intent of the roll-forward regulations.

Recommendation 4: The Commission should allow the 2002-03 capital expenditure under-recovery, as this is consistent with the intent of government policy.

2.5 Alternative Capex Allowance

The Commission presents an 'alternative capex approach' in appendix C of the Draft Decision. Transend supports any move towards light-handed regulation, and we believe that the Code does provide for such arrangements. However, we are 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 must 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 is 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 develop and resolve over the coming months and may be a matter for the review of the Draft Statement of Regulatory Principles.

Recommendation 5: Following the Final Decision, the Commission should undertake to establish a framework to determine those activities that should be revenue-capped and those activities that can be subject to 'more light-handed' forms of regulation. The Commission should provide guidelines as to how 'more light-handed regulation' may be applied in practice. The Final Decision should be sufficiently flexible to allow these guidelines to be implemented without systematically disadvantaging Transend or Transend's customers.

3. Operating expenditure

The Commission's draft operating expenditure allowance over the forthcoming regulatory period averages the 2002-03 actuals[2]. This is despite acknowledged increases in scope over the 5.5-year period. By 2008-09 the operating expenditure allowance is less than 2002-03 actuals. Transend considers that the draft operating expenditure allowance is:

a. not sustainable in terms of minimising long-term operational costs

b. not sustainable in terms of ensuring commercial returns to shareholders.

Transend is extremely disappointed that the Draft Decision has largely accepted all of GHD's recommendations with regard to operating expenditure. In its response to the GHD report (July 23), Transend examined the differences between the analysis described in the narrative of the report and GHD's conclusions using its 'alternative opex trend'. There remains an unexplained gap of $12 million between the text in GHD's report and its conclusions.

The Draft Decision does not make any reference to Transend's analysis of the GHD report or the $12 million gap. Instead, the Draft Decision summarises Transend's submission on the GHD report as follows:

> Transend has several concerns with GHD's trend analysis, mainly that the recommendation to reduce its total claim by $35m over the regulatory period was unattainable without compromising service levels. (page 58)

Transend would like to make it clear that its principal concerns with regard to the operating expenditure analysis in GHD's report (as expressed in our 23 July submission) are:

- GHD's report consists of two distinct parts, which are inconsistent with one another.
- The first part of GHD's analysis consists of 15 pages (pp. 59-73) of 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.
- The second part of GHD's analysis, 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.

2 Exclusive of ancillary services and expenditure on non-regulated items

- The report does not contain any sound analysis to support the recommendations for operating expenditure that are included in the second part of the chapter, including the imposition of a 2% efficiency factor.

In Transend's view, it is essential that the Commission revisits the substance of GHD's report instead of relying exclusively on GHD's conclusions.

Transend accepts that the Commission must rely to some extent on the expert advice it receives from its appointed consultants. However, where this advice is demonstrably in error, Transend believes that the Commission should adjust its finding accordingly. In Transend's view, the identified $12 million gap between GHD's text and its conclusions amounts to an error which must be addressed, if not resolved, by the Commission.

3.1 Example – Connections and Development

To assist the Commission in isolating a demonstrable error, Transend would like to highlight GHD's approach to Connections and Development forecasts. To illustrate Transend's concerns, Table 7-1 from GHD's report is reproduced below. This table shows Transend's major operating expenditure categories from 2000-01 to 2008-9, including Connections and Development.

Table 7-1 Transend's Historic and Proposed Operating Costs 2000/01 to 2008/09

(Amounts are actual $ for 2001/02 and prior, and real 2002/03 $ for forecasts.)

Cost Category	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09
Corporate	4.47	6.66	7.40	7.29	7.10	7.47	7.90	8.07	7.84
Connections & Development	1.92	1.56	2.93	3.51	4.12	4.46	3.62	3.56	3.61
Transmission Operations	1.97	1.68	1.73	2.83	2.68	4.56	4.28	4.29	4.32
Network Group	12.06	12.49	13.11	17.42	21.46	20.68	21.75	19.68	20.04
Total (1)	**20.42**	**22.39**	**25.14**	**31.05**	**35.36**	**37.17**	**37.55**	**35.59**	**35.81**
Overheads Recovered	-2.13	-2.22	-2.45	-2.45	-2.45	-1.20	-1.20	-1.20	-1.20
Opex TOTAL	**18.29**	**20.17**	**22.72**	**28.60**	**32.91**	**35.96**	**36.35**	**34.39**	**34.61**

'(1) Excludes Overheads recovered

In relation to Connections and Development, Transend's cumulative forecast operating expenditure from 2003-04 to 08-09 (including only 6 months of 2003-04 data) is $21.125m.

GHD has based its 'alternative opex trend' analysis on 2001-02 expenditure, which was $1.56 million for Connections and Development. This base level of operating expenditure multiplied by 5.5 years of the new regulatory period provides a base operating expenditure allowance for Connection and Development of $8.58m.

Table 7-8 in GHD's report provides an additional operating expenditure for Connection and Development. This additional allowance and the base $1.56 million allowance is reproduced in Table 2 below.

Table 2: GHD operating expenditure analysis – Connections and Development (2002-03 $m)

	03-04	04-05	05-06	06-07	07-08	08-09	Total
GHD's base allowance (Table 7-1)	**0.78**	**1.56**	**1.56**	**1.56**	**1.56**	**1.56**	**8.58**
GHD's additional allowance (Table 7-8)	0.00	0.02	0.09	0.09	0.09	0.09	**0.38**
GHD's C&D operating expenditure allowance	**0.78**	**1.58**	**1.65**	**1.65**	**1.65**	**1.65**	**8.96**

Table 7-5 of GHD's report suggests that NEM-related Connection and Development costs have been allowed as a separate item. This additional NEM-related Connection and Development expenditure amounts to a further $5.75 million allowance over the regulatory period. Therefore, GHD's conclusions provide an operating expenditure allowance of $14.41 million ($8.98 million + $5.75 million) for Connections and Development compared to Transend's forecast of $21.125 million – a difference of $6.415 million.

In both absolute and percentage terms, a reduction of $6.4 million in forecast Connection and Development operating expenditure is not sustainable. It represents a 30% reduction from Transend's forecast. Given the magnitude of the proposed reduction, GHD and the Commission should provide detailed substantiation and analysis in support of its proposed reduction. It is noted that Transend has been required to provide very detailed substantiation of its forecasts to GHD as part of their review process. The same rigour has not been reflected in the Draft Decision.

The GHD report provides no support for such a large reduction in Connection and Development expenditure. GHD's comments in relation to Connection and Development expenditure are reproduced below in full:

> Connections and Development (C&D) Expenditure is forecast to increase from the Application base (2003/04) figure of $3.51m by $0.6m in 2004/05 and a further $0.3m in 2005/06, a total of $0.9m in two years. These increased costs are primarily attributable to the costs associated with entry into NEM. Transend has no previous experience of this area from which to draw, and advised that ElectraNet's recent NEM Entry costs were used as a guide when developing Transend's forecasts. These NEM Entry costs have been separated from the base C & D expenditure and considered further in Section 7.10.
>
> The Application indicates that another factor contributing to the C&D forecast increase is the need to boost resources to improve Transend's past underperformance in meeting customers' requests for connection to the grid and to meet future proposed connections. GHD's review process indicates that Transend has under-resourced this function, and other stakeholders have acknowledged this. Consequently, some additional resources appear to be justified, however, their extent is unclear and this aspect is further considered in GHD's overall trend assessment. GHD's report, June 2003, page 62.

These GHD comments do not provide any guidance as to why $6.4 million should be cut from the Transend's Connection and Development forecast. GHD do not explain why the additional $90,000 per annum included in the 'alternative trend assessment' is considered adequate to address the acknowledged under-resourcing of the group. This appears to provide a clear indication that the alternative trend analysis is not well considered and should not be relied upon.

3.2 Way forward

As noted earlier, Transend has identified a $12 million gap between GHD's analysis of operating expenditure, and its proposed 'alternative opex trend'. A significant proportion of this gap is attributable to Connection and Development expenditure, and for this reason we have focused on this cost category by way of example.

As a way forward, Transend would be willing to accept the 'alternative opex trend' analysis, providing that a reasonable proportion of the identified $12 million gap was addressed in the Commission's final decision. In Transend's view, the identified $12 million gap demonstrates that the alternative opex trend is not soundly based. The Commission's final decision should explicitly examine whether there is such a gap, and suggest a pragmatic way in which the gap may be shared between customers and Transend. At present, the Draft Decision wrongly assumes that GHD's 'alternative opex trend' is soundly based, even though Transend has identified serious shortcomings with it. Transend very much hopes that this oversight can be addressed in the Final Decision.

Recommendation 6: The Commission should explicitly examine whether there is a gap between GHD's narrative and its 'alternative trend', and suggest a pragmatic way in which the gap may be shared between customers and Transend.

3.3 Efficiency 'dividend'

As noted in our 23 July submission, GHD's 'alternative opex trend' proposed a $35 million reduction in operating expenditure from the levels forecast by Transend. An important component of this proposed reduction is the imposition of a 2% per annum efficiency gain or 'dividend' (see p 56 of the Draft Decision). In Transend's view, the imposition of a 2% efficiency 'dividend' in addition to the impact of GHD's 'alternative opex trend' is unwarranted. To illustrate this point, we reproduce below, three of GHD's findings on page 77 of their report:

> 5. The increase in the Application forecast Opex during the RP is due primarily to two major factors. (i) NEM Entry /Basslink that is forecast to cost $30.28m over the period 2002/03 and 2008/09, with a projected ongoing annual cost thereafter of $5.38m p.a., and (ii) Increase in Maintenance as a result of Transend's 'bottom up' review of the current condition of all of its Transmission Assets and the need to employ additional staff to improve its general management during the RP.
>
> 6. Processes for technical assessment of maintenance Opex appear to be reasonable and the majority of the work is technically supported by reasoned argument and/or CBA. There does not appear to be adequate consideration providing alternative levels of service, in order to provide a rational basis for deciding tradeoffs between cost, timing and risk in conjunction with stakeholders and supported by risk based assessment.

> 7. An increase in costs are incurred as a result of the need to provide system control functions and the decision to maintain a system control backup. The maintenance of the duplicate system was extensively reviewed and deemed appropriate by the Tasmanian Government when the NEM Entry /Basslink was approved.

These three findings support Transend's view that GHD has largely found Transend's forecast operating expenditure to be justified. However, we recognise that GHD identified two main areas of concern in its findings, namely:

> 2. While Transend has substantially reviewed its costs, it has made claims that cost efficiencies have been built into the Application. However, Transend advised that it was difficult to assess total efficiency gains against the historical expenditure for 2001/02, and quantification of how future cost efficiencies were built into expenditure forecasts had not been provided in support of the statements in the Application.
>
> 3. Limited evidence of a systematic risk/cost/benefit trade off or risk-managed approach to investment decisions was sighted. Transend indicated that prioritized issues were addressed and expenses were cut back to fit resources rather than undertaking a comprehensive risk/cost/benefit analysis. (page 77)

Transend notes that GHD's report does not seek to quantify the appropriate adjustment to Transend's operating expenditure forecasts to address these concerns. Instead, GHD appear to use these concerns as justification for adopting an 'alternative opex trend'. In Transend's view, it is excessive to apply an efficiency 'dividend' of 2% to an 'alternative opex trend' which is imposed essentially to address efficiency concerns. This approach imposes a double-penalty on Transend, and is not justified by the GHD report.

Transend notes that the Commission has not applied such an efficiency 'dividend' in any other TNSP revenue determination. Whilst Transend acknowledges that an efficiency target is not inappropriate under the NEC, our view is that GHD's 'alternative opex trend' already imposes a very tough approach. Experience with OTTER's revenue determination has shown that the efficiency target imposed at the previous determination was unattainable.

3.4 Inconsistent approach

In its decision for SPI PowerNet, the Commission allowed a 2% contingency operating expenditure provision for unidentified risks.

> This amount covers events that cannot be anticipated and which are not covered by specific risk allowances or included in the pass-through rules.
>
> …In view of the potential cost increases that may occur but which cannot be predicted, the Commission acknowledges that a contingency allowance per se is reasonable and considers a 2 per cent provision as proposed by SPI PowerNet to be appropriate in the circumstances. (page 80 Decision: Victorian Transmission Network Revenue Caps 2003-2008).

The allowance of a 2% contingency provision for potential cost increases seems markedly at odds with the provision of a 2% efficiency 'dividend' reduction for Transend, in a cost environment the Commission acknowledges as uncertain. Transend considers the differing treatments to be inequitable.

The Draft Decision (page 65) rejected Transend's claim for an efficiency bonus, noting that:

> The purpose of an efficiency incentive mechanism is to encourage a firm to reveal its actual efficient costs, resulting in cost reductions over time. In Transend's case its opex costs are increasing substantially from its current regulatory period to the forthcoming period. Hence the ACCC considers that the value of an efficiency mechanism is not clear until such time as Transend's opex costs stabilise.

In Transend's view, it is also inequitable that Transend is not allowed to earn an efficiency bonus until its costs stabilise, but by the same token an efficiency penalty is imposed. Transend believes that the Commission should take a consistent approach to allowing efficiency bonuses and imposing penalties. In any event, bonuses and penalties need to be carefully measured to ensure that regulated businesses do not face windfall gains or losses. At present, the Draft Decision imposes an unsustainable reduction in operating expenditure over a period which all parties note is very uncertain.

The intent of regulation is to incentivise regulated companies to reveal their efficient costs. Efficiency savings are to be shared between investors and customers. By imposing the 2% efficiency 'dividend' allocated entirely to customers, the Commission has strayed from the intent of incentive regulation.

Recommendation 7: The Commission should remove the cumulative 2% operating expenditure efficiency 'dividend' as its application is inconsistent with previous Commission decisions and with incentive regulation.

3.5 Benchmarking

The Commission argues that they have also used benchmarking to 'sanity check' GHD's operating expenditure recommendations.

> However, overall the ACCC considers that its benchmarking shows, particularly in relation to opex per asset base, opex per line length and opex per substation, that GHD's recommended opex allowance is reasonable. (page 64)

Based on Transend's operating environment, and diseconomies of scale, Transend's costs of operation would be expected to be high relative to the larger mainland TNSPs. However, the Commission's 'benchmarking' in table 5.5 shows that Transend's operating expenditure request is only highest for one measure (operating expenditure per GWh). For operating expenditure/substation it is the lowest cost network. Comparisons later in the period are slightly less meaningful, as data for TransGrid and Powerlink is not available.

Transend also notes that although the Commission has benchmarked TNSPs' operating expenditure per MW (demand-side capacity), the Commission has not benchmarked operating expenditure per generation-capacity MW (supply-side capacity). This is despite hydro-generation being a driver of the size and operating costs of the Tasmanian transmission network.

Transend considers that the benefits of the type of benchmarking used by the Commission are dubious. However, following the Commission's lead, and including Transend's operating expenditure request in the analysis of Figures 5.1 to 5.5, it can be seen that Transend's operating expenditure request – while higher than the GHD allowance – is reasonable. Taking proper account of economies of scale and operating conditions, relative to other Australian TNSPs, would show Transend's operating expenditure request to be even more reasonable.

4. WACC

The Commission's views on issues relating to the estimation of WACC are outlined on page 69 of the Draft Decision as follows:

> Electricity transmission is a highly capital intensive industry where return on capital generally accounts for about half of the revenue allowed. Relatively small changes to the cost of capital could have a substantial impact on the AR.
>
> If the return on equity is too low, the regulated network will be unable to earn sufficient returns to the owner, reducing the incentive to reinvest in the business. Conversely, if the return on equity is too high, networks will have a strong incentive to overcapitalise, creating inefficient investment.
>
> AR translates into prices for users. Eventually AR would mean higher prices (sic). Therefore, correctly assessing the WACC is important.

Transend concurs that it is very important for the regulator to assess an *appropriate* WACC, having regard to the following fundamental considerations:

- Firstly, any estimate of the WACC must necessarily be based on data that is subject to a large degree of statistical uncertainty. Any point estimate of the WACC made by a regulator for the purpose of capping a TNSP's revenue ultimately involves subjectivity and judgement.

- Secondly, as recognised by the Commission, there are costs associated with setting a WACC that is inappropriately high or low.

In relation to this second consideration, page 46 of the Draft Decision (in the chapter on capital expenditure forecasts), states:

> The ACCC considers that a secure and reliable transmission system is vital to an efficient electricity market. The Productivity Commission has argued that it is better to err on the side of overinvestment in the event of regulatory uncertainty, as the costs of under investment outweigh the costs of overinvestment.

Transend strongly concurs with these statements. One of the guiding principles espoused by the Productivity Commission is that regulators should not be overly ambitious or precise in their efforts to remove perceived 'monopoly rents' from the income streams of regulated businesses. The Productivity Commission has noted that this principle has a sound public policy rationale, given that:

- there is a significant risk that aggressive regulatory decision-making may severely diminish incentives for on-going investment in infrastructure

- the cost to society as a whole of insufficient infrastructure investment is far greater than the potential cost associated with regulatory decisions that are expressly aimed at providing incentives for on-going investment

- the information that is available to regulators in their decision-making is, unavoidably, characterised by a high degree of uncertainty

- given this uncertainty, and the potential costs to society of overly aggressive regulatory decisions, there is a strong case for regulators' decisions to err in favour of encouraging more, rather than less infrastructure investment.

These key themes were endorsed by the Commonwealth Government in its interim response of September 2002 to the Productivity Commission's Final Report.

Transend is concerned that in its assessment of the WACC, the Commission appears to have given insufficient attention to the guiding principles articulated by the Productivity Commission. As a consequence, Transend considers that the Commission's WACC estimate is unduly biased toward providing a lower, rather than a higher rate of return.

In this context it is noted that some stakeholders (including the Commission itself) have described Australian regulators' WACC estimates as comparing very favourably to those of overseas regulators. This issue is the subject of a detailed paper published last month by NECG. A recent article (written by Henry Ergas, Managing Director of NECG) provides an overview of NECG's research:[3]

> Faced with mounting criticisms of low returns, the Australian Competition and Consumer Commission argues the returns it allows regulated utilities are 'generous' compared with those overseas. But a recent survey my colleagues and I have conducted of more than 100 regulatory decisions shows that this is not true.
>
> The survey, *International Comparison of Weighted Average Cost of Capital Decisions* (a submission to the Productivity Commission Review of the Gas Access Regime), shows regulated rates of return in the United States are substantially more generous to investors than those in Australia - and this is despite more than a century of regulation in the US. Similarly, returns in the UK, while superficially comparable to those in Australia, are significantly higher once differences in market risk are taken into account.
>
> In the US telecommunications sector, tariffs for interstate service are referenced from the Federal Communications Commission's cost of capital benchmark of 11.25 per cent, which is 6 per cent above long-term US bond rates.
>
> In the UK, the telecommunications regulator, Oftel, determined that BT required a cost of capital 5 per cent above the risk-free rate for its network operations.
>
> By contrast, the increment applied by the ACCC on Telstra's Public Switched Telephone Network in its last decision in 2000 was 2.65 per cent. The real difference is even greater because investors generally require greater returns in Australia than the US and UK because of higher market risk.
>
> In the electricity transmission sector, the ACCC argues that returns less than 3 per cent above the long-term bond rate are appropriate for Australian businesses.
>
> In the US, despite electricity companies receiving returns about 5 per cent above the long-term bond rate, the Federal Energy Regulatory Commission is providing further increments on the cost of capital for firms to engage in behaviour to promote investment.

3 *Australian Financial Review*, 23 September 2003.

Transend considers that there is considerable scope for the Commission to revise and increase its estimate of the WACC, if the principles articulated by the Productivity Commission are adopted and applied.

There are four main areas in which the Draft Decision adopts an unduly aggressive approach. Transend's comments on each of these areas are set out below.

4.1 Beta

As noted on page 82 of the Draft Decision, the equity beta is a function of:

- the undiversifiable (systematic) risk of the asset
- the level of debt (financial leverage or gearing) employed in the financing of the asset.

Consequently, when deriving estimates of the proxy equity beta from market data, or when comparing the equity beta values of two different firms, it is essential that appropriate adjustments be made for any differences in the levels of gearing employed by different firms.

Notwithstanding this, page 83 of the Draft Decision proceeds to state:

> The ACCC has used an equity beta of one in its previous revenue cap decisions, suggesting that the TNSPs face the same volatility as the market. However, there is a view that gas and electricity transmission businesses are less risky as their earnings are more stable than the market portfolio—suggesting an equity beta of less than one.

Transend does not accept that it is valid to directly compare the equity beta of a 60% geared TNSP with the market average equity beta of 1.0, because the average level of gearing employed in the market is likely to be substantially less than 60% debt to total assets. Therefore, in accordance with the approach applied by the Commission itself (as described on page 82 of the Draft Decision) it is necessary to make adjustments for different gearing levels before making any direct comparisons of equity betas.

A good basis on which to make such comparisons is to compute asset (ungeared) betas. This approach was adopted by the Victorian Office of the Regulator-General (ORG) in its 1998 Gas Access Arrangements Review.[4] The ORG's 1998 analysis found that:

- the average level of gearing employed by a sample of 47 of Australia's top 100 listed companies was around 33% debt to total assets
- this implied an average asset beta for the sample of around 0.7
- applying a gearing assumption of 60% debt to total assets to the sample produced an estimated equity beta of around 1.6.

By comparison, the Draft Decision proposes to apply an asset beta to Transend of 0.4, and a (60% geared) equity beta of 1.0. Based on the ORG's 1998 analysis, the proposed equity beta of 1.0 reflects an assumption that the relative systematic risk of electricity transmission

[4] Office of the Regulator-General, Victoria, *Staff Paper Number 1: Weighted Average Cost of Capital for Revenue Determination - Gas Distribution*, 28 May 1998.

is less than two-thirds of that of the market as whole, after adjusting for the impact of gearing on the equity beta. Contrary to the statement appearing on page 83 of the Draft Decision (cited above) this clearly reflects an assumption that the earnings of electricity transmission businesses are substantially less volatile than those of the market portfolio.

NECG's recent submission to the Productivity Commission's review of the gas access regime compared the asset betas provided by a sample of nine regulatory decisions from Australia, the UK, Ireland and Canada. NECG noted:

> These decisions show a concentration of decisions providing an asset beta of around 0.40. While the sample of non-Australian countries is small, the adjusted results show the ACCC's decisions to be less generous than those in the UK and Ireland, while the transmission decision in New Brunswick provides the lowest estimated asset beta, but a relatively high vanilla WACC margin…
>
> However, note that the [data] excludes the US electricity transmission sector, where FERC is providing return on equity allowances significantly higher than those in the decisions shown…[5]

In the United States, the Federal Energy Regulatory Commission is providing additional returns to transmission companies, to strengthen incentives for those companies to invest in the transmission system. NECG estimates that a recent FERC decision on the cost of capital for the MidWest ISO implied an asset beta value of 0.74.

The adoption by the FERC of a policy of actively encouraging investment in transmission infrastructure is timely, in the wake of the recent blackout that affected much of North Eastern USA and South East Canada.[6] These recent events provide a stark example of the very high contingent costs associated with under-investment in infrastructure. These events therefore provide a powerful practical validation of the basic principles espoused by the Productivity Commission.

Based on the ORG's 1998 analysis, and the analysis completed recently by NECG, a plausible value for a TNSP's asset beta lies in the range of 0.4 at the lower bound, through to around 0.7 at the upper bound. A value at the upper limit of this range would be broadly consistent with the Australian stock market's asset beta; it would also be comparable to

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5 NECG, *International comparison of WACC decisions*, September 2003, page 71.

6 On August 15, the publishers of *Restructuring Today* (a leading newsletter focused on the opening up of competitive retail and wholesale markets and the convergence of energy and communications in the US) released a special bulletin on the blackouts. It stated:

> "Ken Malloy, CEO of the Center for the Advancement of Energy Markets (CAEM) -- had predicted the blackout in a report last year. He forecast "a major blackout [since the] laws of probability suggest that we are due for a reminder of how old our infrastructure is." CAEM has not been the only one waving a red flag about the nation's aging grid. RJ Rudden Associates in Hauppage, NY, re-released reports on the *Next Big Crunch: T&D Capital Expenditures and Distribution Reliability* and *Power Quality -- The Next Industry Time Bomb*. The two point to a lack of clear and coordinated government policy on transmission system development and a pattern of industry-wide underspending on electric transmission and distribution infrastructure.
>
> The authors predict future deterioration in electric system reliability if inadequate spending on infrastructure continues. Leonard Hyman, author of the first report, suspects under investment in the grid played a major role in the blackout. Hyman thinks utilities should be spending about $63 billion for distribution improvements and about $25 billion for transmission upgrades over the next five years."

recent FERC decisions in which higher rates of return have been deliberately provided to entice higher levels of investment in transmission infrastructure.

In view of these considerations, Transend believes that the Commission's proposed asset beta of 0.4 (and equity beta of 1) lie at the absolute lower limit of the range of beta values. Application of the principles articulated by the Productivity Commission, particularly in light of the lessons from recent experience in the United States would suggest the adoption of a value for the asset beta well in excess of the 0.4 proposed in the Draft Decision.

4.2 Market Risk Premium

Empirical evidence based on the historical market risk premium (MRP) suggests a value in the range of 6 to 8%. A detailed summary and review of this evidence is provided by the QCA[7], which stated:

> The findings of Australian academic studies and regulatory decisions suggests that the MRP has a range of 6 to 8%.[8]

As noted in Transend's revenue cap application, adopting the mid point of this range suggests a point estimate for the MRP of 7%.

Notwithstanding this, all of the Commission's revenue cap decisions have adopted an MRP value of 6%. In addition, the Draft Decision notes that some interested parties believe that the MRP is declining, and that the Commission should adopt a lower MRP. Page 79 of the Draft Decision states:

> The ACCC's assessment of the MRP, although based on more traditional views, still remains between 5 per cent and 7 per cent. The ACCC has chosen the mid-point of this range i.e. 6 per cent. This is consistent with the Lally study for the ACCC, which recommended an MRP of 6 per cent.

Transend does not accept that there is, or has been, Australian evidence to support a modified range of 5 to 7% for the MRP. The company also considers that a long-term historical average is the best method for estimating the MRP, because it is transparent, reasonably replicable, and demonstrably more statistically robust than the other approaches available.[9] While other methods are available, (for instance, 'forward-looking' methods based on market forecasts and use of the dividend valuation model) they encompass far greater estimation errors than the historical estimates.

Notwithstanding the evidence to the contrary, Transend adopted a value of 6% for the MRP in formulating its revenue cap application. This should not be interpreted as acceptance of the Commission's suggestion that a value of 6% reflects the mid point of a reasonable range. Rather, Transend's proposal reflects the application of a pragmatic approach to the estimation of an uncertain variable, in the light of the Commission's clear predisposition to adopting an MRP value of 6%. Based on the available empirical evidence, Transend considers that a value of 6% represents the absolute lower bound of the plausible range.

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7 The evidence is presented in Table 8 of QCA Working Paper 4, *Issues in the Estimation of Queensland Rail's Below Rail Coal Network Expected rate of Return* page 27.

8 QCA, *Proposed Access Arrangements for Gas Distribution Networks*, October 2001, page 216.

9 See Gray S, (2001) *Issues in Cost of Capital Estimation*, a copy of which is available from: http://www.reggen.vic.gov.au/PDF/2001/SubUQBS_GasPosPapOct01.pdf

Given the views and principles articulated by the Productivity Commission, Transend suggests that there is ample scope for the Commission to reconsider its position on the MRP, and to adopt a value that is more consistent with the long term empirical evidence. We suggest that an MRP value of 7% should be adopted.

4.3 Term of the risk free rate

Page 72 of the Draft Decision, acknowledges that:

- Some finance experts support the Commission's view that the term of the risk free should match the duration of the regulatory period.
- However, other experts believe that bond rates with terms matching the life of the assets should be used. The effective lives for most transmission assets far exceed 10 years, so these experts suggest that 10 year bond yields should be used in the calculation as it represents the most liquid bond with the maturity comparable to the life of the assets.
- All other Australian regulators use a 10 year bond as the risk free rate.
- Schedule 6.1 of the National Electricity Code also appears to support the application of a 10 year bond rate as the risk free rate.

Notwithstanding these considerations (and the arguments presented by Transend in its revenue application) the Commission continues to adopt a practice of matching the duration of the regulatory period and the term of the bond used to establish the risk free rate. Given present capital market conditions, this results in the Commission's estimate of the WACC being around 20 basis points lower[10] than that which would be estimated by any of the Australian state regulators, all else held constant.

On page 72 of the Draft Decision, the Commission states that it prefers to match the duration of the regulatory period and the term of the risk free rate because:

- the regulatory framework seeks to provide an efficient return on capital
- the regulatory asset value is supported by the expected cash flows during the regulatory period.

The stated reasons imply that the Commission is seeking to achieve a spuriously high level of precision in estimating the WACC. In so doing, the Commission is adopting an approach that results in its WACC estimate being biased towards a lower value, compared with that which would be estimated by each of its State-based peers. Such an outcome appears to be at odds with the principles espoused by the Productivity Commission in its review of the national access arrangements.

In addition, pages 72 and 73 of the Draft Decision state:

> Davis considered that long-term interest rates will, on average, exceed short-term interest rates for reasons other than expectations of future increases in interest rates. Therefore,

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[10] As at 3 October 2003, the difference between the yields on 5 year and 10 year Commonwealth fixed coupon bonds war 19 basis points.

> the use of the longer term interest rate as a proxy for the risk free rate will lead to higher regulatory cash flows than if the short-term rate were used.
>
> Davis demonstrated that using the interest rate on bonds with maturity periods equalling the regulatory period, to derive the required return for the regulated asset, generates expected cash flows which are fairly priced in net present value terms. Furthermore, using a maturity period which exceeds the regulatory period provides excess returns for the regulated asset if there is a positive term premium in the yield curve, unrelated to interest rate expectations.

Again the overall approach adopted by the Commission in its consideration of this issue seems at odds with the Productivity Commission's suggestion that regulators should be more pragmatic and not be 'too ambitious in their approach' to identifying and eliminating investor returns that are potentially in excess of so-called 'normal' levels.

In light of the principles espoused by the Productivity Commission, the views of academics and practitioners in support of the application of the 10 year rate, and the practice adopted by all other Australian regulators, Transend submits that the Commission should apply the 10 year bond rate as the risk free rate.

4.4 Cost of Debt

The Commission has examined the credit rating of Australian electricity transmission and distribution businesses in determining a benchmark debt margin. Although the Commission makes reference to the credit ratings of Envestra (BBB) and GasNet (BBB+), Table 6.1 (reproduced below) in the Draft Decision explicitly excludes these companies.

Table 6.1 Credit ratings of electricity companies

Company	Long-term rating	Actual Gearing (%)
Ergon Energy	AA+	46.9
Country Energy	AA	66.7
EnergyAustralia	AA	52.5
Integral Energy	AA	55.8
SPI PowerNet	A+	82.4
Citypower Trust	A-	65.4
ETSA Utilities	A-	62.4
Powercor Australia	A-	42.9
United Energy	A-	41.9
ElectraNet	BBB+	74.9

Source: Standard and Poor's, *Australian Report Card Utilities*, April 2003

The Commission's view is that the average credit rating of the companies listed in Table 6.1 is an A-rating, and therefore this rating ought to apply to Transend.

The only basis for excluding Envestra and GasNet as comparators appears to be that their gearing is above the benchmark level of 60%. However, the Commission also notes that Origin and AlintaGas have credit ratings of BBB+ and BBB respectively, with gearing levels below the benchmark. This analysis serves to highlight that gearing is only one of a number of factors in determining a company's credit rating. As the Commission's approach is to take a broad average of comparator companies' credit ratings, there is no basis for excluding Envestra, GasNet, Origin and AlintaGas from Table 6.1. A simple average of their gearing is 56%, which is very close to the benchmark.

Furthermore, the principles of competitive neutrality outlined in the Code require the Commission to establish the WACC parameters as if Transend were privately owned[11]. Transend is concerned that the companies listed in Table 6.1 with a rating above A are all Government-owned, and therefore should be excluded from the sample. Government-owned companies tend to enjoy an enhanced credit-rating compared to privately-owned TNSPs, as the former entities are ultimately supported by a highly credit-worthy owner. The inclusion of Government-owned entities in Table 6.1 further biases the Commission's assessment of the average credit rating upwards.

To address these issues, Transend has reproduced Table 6.1, excluding Government-owned entities and including the comparators that the Commission had excluded without explanation.

Table 3: Revised Table 6.1 from the Draft Decision

Company	Long-term rating	Actual gearing %
Citypower Trust	A-	65.4
ETSA Utilities	A-	62.4
Powercor Australia	A-	42.9
United Energy	A-	41.9
ElectraNet	BBB+	74.9
Envestra	BBB	80.0
GasNet	BBB+	67.0
Origin	BBB+	29.0
AlintaGas	BBB	49.0

The revised table 6.1 above indicates that the average credit rating is either BBB+ or A-. Transend believes that its greater dependence on major industrial load compared to the comparator companies suggests that a credit rating of BBB+ is most appropriate. The debt premium should be adjusted accordingly.

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11 Schedule 6.1 of the NEC states:

> "Setting target rates of return for Government business enterprises on the basis of the marginal rate of return of private sector investments of similar risk is a central part of this even-handed treatment.
>
> "Basing target rates of return for public enterprises on the return from alternative private sector investments should result in sound investment and operational decisions at the Government enterprise level and balanced investment between the public and private sectors."

4.5 Sampling period

The Commission has accepted Transend's proposal to sample the risk free rate over a 10 day period. This approach contrasts with the Commission's position as outlined in the Draft Statement of Regulatory Principles, but is consistent with its recent decisions in relation to SPI PowerNet and ElectraNet revenue caps.

Transend notes, however, that the 10 day sampling period is tied to the date of the Commission's final decision. Whilst it is appreciated that the Commission wishes to use the most recent market data, the uncertainty as to the precise timing of the Commission's final decision creates some additional financing risk for Transend. It is noted that this timing issue is more acute if a 10 day average is adopted, compared to a 40 day average.

Transend therefore would like the Commission to determine the 10 day average period independently of the date of the Final Decision, so that Transend's financing risk can be minimised. There does not appear to be any detriment to consumers, the Commission or Transend if this approach were to be adopted.

4.6 WACC Conclusions

Transend considers that in its assessment of the WACC, the Commission appears to have given insufficient attention to the guiding principles articulated by the Productivity Commission in its recent review of the national access regime. As a consequence, Transend considers that the Commission's WACC estimate is unduly biased toward providing a lower, rather than a higher rate of return.

There are four main areas in which the Draft Decision adopts an unduly aggressive approach. These are (in order of decreasing materiality): the beta; the Market Risk Premium; the term of the risk free rate; and the debt premium.

Transend considers that there is considerable scope for the Commission to revise and increase its estimate of the WACC, if the principles articulated by the Productivity Commission are adopted and applied, particularly in light of the lessons emerging from recent experience in the transmission sector in the United States.

Recommendation 8: The Commission should adopt an approach to assessing the WACC that is consistent with the principles articulated by the Productivity Commission. Specifically, the Commission should:

a) adopt an equity beta value of 1.12

b) adopt an MRP value of 7%, in light of the empirical evidence

c) apply the 10 year bond rate as the risk free rate

d) apply a benchmark credit rating of BBB+, and determine the debt premium accordingly

e) determine the 10 day average period independently of the date of the Final Decision.

5. Asset valuation

Transend is concerned that the Commission considers that transmission line route acquisition costs (which include transmission line route selection and survey, planning and regulatory costs, and legal expenses) should be valued using actual historic costs adjusted for inflation. Transend considers that easement acquisition costs should be valued in accordance with the Depreciated Optimised Replacement Cost methodology used for other transmission assets, and that the Minister's value for Transend's easement acquisition costs is appropriate.

Transend notes that its easements are valued in accordance with historic easement compensation costs adjusted for inflation, in accordance with the Commission's stated preference.

6. Service Standards

6.1 Definitions

The Commission has not made any comment on the service standard definitions for 'Circuit Availability' and 'Loss of Supply Events Frequency Index' contained in Transend's revenue cap application (Tables A3 and A4 of Appendix 4).

Transend's definitions are more comprehensive than those proposed by the Commission in the Draft Decision, and define some critical exclusions which the Commission has not addressed (for example: outages to install wholesale energy metering, required for NEM entry).

Transend and the Commission will need to reach agreement on the service standard definitions. Until such agreement is reached, Transend intends to measure its performance in accordance with the more comprehensive definitions contained in Tables A3 and A4 of its revenue cap application.

Recommendation 9: The Commission should accept Transend's definitions for the purposes of service standard reporting, until alternative definitions are agreed.

6.2 Financial year

Transend is disappointed that the Commission has not accepted Transend's proposal to report against its performance incentive scheme on a financial year basis. Transend reports service performance to OTTER, customers and ESAA on a financial year basis. Transend is also required to report its expenditure annually to the Commission on a financial year basis. Transend's operating expenditure forecasts were based on financial year reporting.

Transend recommends that the performance incentive scheme be adjusted to a financial year scheme, with reporting commencing from the 2003-04 financial year.

Recommendation 10: The Commission should base Transend's performance incentive scheme on a financial year, with reporting commencing from the 2003-04 financial year.

7. Conclusion

Transend looks forward to working with the Commission to address the issues raised in this submission, including the attached table.

Transend's principle recommendations for the Commission are summarised below. Transend requests that the Commission address each recommendation in their Final Decision.

1: If the Commission is to apply a 10% reduction to GHD's 'unrationalised' capital expenditure allowance, then this should be applied correctly so that the proposed reduction is $24.5 million rather than $34.1 million.

2: To be consistent with GHD's report, the Commission should either

a) allow an additional amount for generator-related capital expenditure within the revenue cap

OR

b) provide for the recovery of generator-related projects outside the revenue cap.

3: The Commission should ensure that the Final Decision adopts a more robust and sustainable approach to the clawback issue, having regard to the Commission's recent statements in the discussion paper on the Draft Statement of Regulatory Principles.

4: The Commission should allow the 2002-03 capital expenditure under-recovery, as this is consistent with the intent of government policy.

5: Following the Final Decision, the Commission should undertake to establish a framework to determine those activities that should be revenue-capped and those activities that can be subject to 'more light-handed' forms of regulation. The Commission should provide guidelines as to how 'more light-handed regulation' may be applied in practice. The Final Decision should be sufficiently flexible to allow these guidelines to be implemented without systematically disadvantaging Transend or Transend's customers.

6: The Commission should explicitly examine whether there is a gap between GHD's narrative and its 'alternative trend', and suggest a pragmatic way in which the gap may be shared between customers and Transend.

7: The Commission should remove the cumulative 2% operating expenditure efficiency 'dividend' as its application is inconsistent with previous Commission decisions and with incentive regulation.

8: The Commission should adopt an approach to assessing the WACC that is consistent with the principles articulated by the Productivity Commission. Specifically, the Commission should:

a) adopt an equity beta value of 1.12

b) adopt an MRP value of 7%, in light of the empirical evidence

c) apply the 10 year bond rate as the risk free rate

d) apply a benchmark credit rating of BBB+, and determine the debt premium accordingly

e) determine the 10 day average period independently of the date of the Final Decision.

9: The Commission should accept Transend's definitions for the purposes of service standard reporting, until alternative definitions are agreed.

10: The Commission should base Transend's performance incentive scheme on a financial year, with reporting commencing from the 2003-04 financial year.

APPENDIX 1:

Capital Expenditure: Comparing Transend's request, GHD's recommendation and the Commission's Draft Decision

	Transend application	Transend application (fixed capex) & SKM report (probability-weighted variable capex)	GHD recommendation	Commission Draft Decision "10% across-the-board cut" to GHD's recommendation	Error 1 Reinstate capex for development projects that have passed the regulatory test	Error 2 Correct for zero allowance for generation-related projects. Method (a) include appropriate capex allowance in revenue cap	Error 2 Correct for zero allowance for generation-related projects. Method (b): allow generation-related projects outside the revenue cap
	(1)	(2)	(3)	(4)	(5)	(5a)	(5b)
FIXED PROJECTS							
Development capex projects that have passed regulatory test	95.8	95.8	95.8	86.2	95.8	95.8	95.8
Development capex projects that have not yet passed regulatory test • Reactive support • George Town rearrangement • Sheffield rearrangement	13.4	13.4	6.9 3.5 3.0 13.4*	12.1	12.1	12.1	12.1
Development capex - fixed	109.2	109.2	109.2*	98.3	107.9	107.9	107.9
Renewal Capex	194.9	194.9	189.3*	170.4	170.4	170.4	170.4
Non-network Capex	26.7	26.7	23.6*	21.2	21.2	21.2	21.2
TOTAL FIXED	**330.8**	**330.8**	**322.1***	**289.9**	**299.5**	**299.5**	**299.5**
Variable projects							
Development capex - customer connection	30	13.8	12.6*	11.3		11.3	11.3
Development capex - generator connection	20	11.8	Excluded	0		11.8 – 10% (based on other ACCC reductions) = 10.6	Outside revenue cap
Development capex - generation-driven shared network	110	34.1	Excluded	0		34.1 – 10% (based on other ACCC reductions) = 30.7	Outside revenue cap
TOTAL VARIABLE	**160**	**59.7**	**12.6***	**11.3**		**52.6**	**11.3**
Reallocation of opex			6.2	5.6		5.6	5.6
TOTAL CAPEX PROJECTS UNDER REVENUE CAP	**490.8 (possible)**	**390.5**	**340.9***	**306.8**		**357.7**	**316.4**
TOTAL CAPEX PROJECTS OUTSIDE REVENUE CAP	**0**	**0**	**45.9***	**0**			**41.3**
TOTAL CAPEX ALLOWANCE	**490.8 (possible)**	**390.5 (probability-weighted)**	**386.8***	**306.8**		**357.7**	**357.7**

Source: (1) Transend application (2) Transend application and SKM Development Plan (provided to GHD) (3) GHD final report (4) ACCC Draft Decision (5) Transend submission on Draft Decision – Recommendation 1 (5a) Transend submission on Draft Decision – Recommendation 2a (5b) Transend submission on Draft Decision – Recommendation 2b

* subject to rationalisation

Transend submission on the Commission's Draft Decision – Detailed comments on text

Capex comments

10% reduction

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	page 5	"The 10 per cent reduction is consistent with the reduction OTTER applied in its previous determinations."	▪ The energy environment in Tasmania has changed markedly since OTTER's previous determination. Consistency with the OTTER reduction does not appear to be a valid basis for selecting an arbitrary reduction of 10%.
	page 48	"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."	▪ GHD did not recommend reductions to development projects that have already passed the regulatory test. ▪ If GHD is to apply a 10% reduction to GHD's 'unrationalised' allowance, then this should be applied correctly so that the proposed reduction is \$24.5 million rather than \$34.1 million. ▪ GHD had already cut other development projects (eg high load growth and generation connection assets and generation-related shared network assets); some renewal projects and some non-network projects. This already represents a significant cut to Transend's proposed capex program. ▪ GHD allowed some expenditure that Transend had re-classified as opex (from capex). However, GHD considered that some of this expenditure should properly be classified as capex. The ACCC have effectively applied a 10% reduction to this capex. This is despite GHD allowing the amount in full, including an amount that remained classified as opex. ▪ The ACCC have verbally informed Transend that their capex allowance must also cover generation connection assets and generation-related shared network assets, even though these were excluded from the GHD allowance. The arbitrary reduction applied by the ACCC is therefore 21% - not 10%. ▪ See notes on impact of renewals on opex.

Clawback

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	page 6	"At the end of the regulatory period the ACCC will compare the actual capex with the allowance and consider clawing back any underspend in the next regulatory period."	▪ Transend rejects any use of 'claw back' as it is contrary to the regulatory principles set out in the National Electricity Code. ▪ This is a also a fundamental departure from the ACCC's views on incentive regulation, expressed in their recent Discussion Paper on the *Draft Statement of Regulatory Principles for the Regulation of Transmission Revenues.*

Capitalisation policy

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	page 37	Table 4.3 Reallocation of refurbishment	▪ GHD reclassified certain expenses (transformer mid-life overhauls and post-insulator replacements) from opex to refurbishment capex. ▪ The ACCC has not explicitly stated whether or not it agrees with GHD's approach. ▪ The ACCC has used the GHD capex recommendation as the basis for the ACCC's forecast, so Transend presumes that the ACCC agrees with GHD's interpretation. ▪ Unless advised otherwise, Transend will amend its capitalisation policy to reclassify these activities as capex.

Other non-regulated "benefits"

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	page 5 page 47	"Some projects in the renewal program have benefits other than transmission (e.g. the overhead powerline ground wire (OPGW) project used for communications)."	▪ Communication infrastructure is an essential part of the transmission network. ▪ The Code requires duplicate communications under section 4.11.2. ▪ While OPGW may provide other non-regulated communication opportunities in the future, Transend's installation is for its own communication needs. ▪ Transend would treat any future non-regulated use of the OPGW in accordance

No.	Reference draft decision	Reference / quote	Comments / Suggestions
			with the ACCC's ring-fencing guidelines.

Alternative capex proposal

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	page 50 Appendix C	Alternative capex approach	▪ See comments in main body of submission

Exclusion from fixed capex allowance (and revenue cap)

No.	Reference draft decision	Reference / quote	Comments / Suggestions

	page 49	Chapter 4 and Figure 4.1	▪ Figure 4.1 should compare Transend, GHD and the Draft Decision on a similar basis. The current figure compares:
			  ▪ Transend's capex request
			  ▪ GHD's allowance
			  ▪ The ACCC's draft decision allowance.
			▪ It is reasonable to presume these are being compared on the same basis. The ACCC has verbally advised that this is not the case.
			▪ The ACCC has advised that its draft decision allowance must cover all new generation connection assets generation-related shared network upgrades, despite these being specifically excluded in GHD's recommended allowance.
			▪ Transend notes that nothing in the text of chapter 4, including Figure 4.1, indicates that Transend must cover the generation-related capex in the draft decision allowance.

Insufficient reasoning or justification

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	page 28	"This [capex] chapter explains the ACCC's considerations in determining Transend's capex allowance. It has assessed whether Transend has struck an appropriate balance between: ▪ alternatives to capex such as increases in opex, demand-side management and new generation ▪ appropriate trade-offs between costs and risks, taking into account customer preferences."	▪ Transend is unable to discover the ACCC's assessment on these matters. For example, where is the ACCC's assessment of whether Transend has struck an appropriate balance between capex and alternatives to capex? Transend notes: ▪ Opex has been substituted for capex: eg Transend's use of dynamic ratings rather than capex augmentation; increased condition based monitoring (capex would be higher if age based). ▪ Transend has investigated demand-side management: eg demand side study as part of southern augmentation regulatory test, which showed that even for the Hobart region, demand side management is not presently an economic alternative to supply-side measures. ▪ New generation options are being investigated: eg Transend is actively looking at gas generation options as a substitute for transmission augmentation in southern Tasmania. ▪ Transend concerned that the ACCC has not made any considered assessment of the costs and risks faced by Transend, taking into account customer preferences. ▪ The ACCC notes, however, that customers are satisfied with their current level of service – and presumably want this level maintained. ▪ GHD (and the draft decision) notes that improved reliability is rarely the only driver for Transend's capex, with obsolescence, technical and environmental compliance, and growth driving the capex program.
	page 5 page 47	"Tasmania's load growth is minimal. Also there would be no increase in the quality of supply, rather Transend claims that the large capex is required to maintain the existing quality." "Transend claims that it needs increased capex to maintain its quality of supply. Given that most customers are happy with their current level of service and that Tasmania's load growth is minimal,	▪ Improving quality and reliability of supply is not the main driver for Transend's capital program. GHD have recognised that reliability is rarely the only driver for Transend's capital works. ▪ Renewal programs are about replacing existing assets. Renewing existing assets is generally to maintain present service levels. ▪ Transend's relatively high level of renewal capex (which GHD acknowledge is lower than an age-based renewal program) is generally to prevent deterioration of

No.	Reference draft decision	Reference / quote	Comments / Suggestions
		Transcend's capex proposal is on the high side."	present levels of supply and to meet compliance needs. ▪ The majority of Transend's development capex program has already passed the market benefits test and been endorsed by the RNPP. ▪ Stating, "most customers are happy with their current level of service and that Tasmania's load growth is minimal" therefore does not provide any grounds for concluding that, "Transend's capex proposal is on the high side".
	page 5 page 47	"The distribution company in Tasmania (Aurora) states that most outages occur in the distribution network. It points to the disparity in the size of capex programs between itself and Transend and argues that better outcomes could be achieved by reallocating capex in a more balanced manner."	▪ Aurora's capital program is a matter for OTTER, not the ACCC. ▪ GHD have noted that Transend's capex program is technically justified. ▪ Due to the nature of the networks, unplanned outages in the transmission network tend to have wider impact than those in distribution networks.
	page 5 page 47	"Transend's capital program is proportionately larger (relative to the RAB) than those allowed for both the South Australian and Victorian networks."	▪ The ACCC has made no reference to any other proportionate factors (eg age or condition of network) between Tasmania, South Australia and Victoria. ▪ A comparison of table 4.4 on page 48 suggests that Transend is not out of step with other TNSPs (eg Powerlink and TransGrid 45%). ▪ However, given the lumpy nature of transmission investment, Transend considers that benchmarking of capex is not a particularly useful tool.
	page 44	"There are several possibilities which could result in sub-optimal outcomes… ▪ Transend delivers the whole capex program, but the timing of individual projects may be delayed to the latter part of the regulatory period."	▪ Response to this concern may be a movement in timing within the regulatory period, rather than an arbitrary 10% cut.
	page 44	"There are several possibilities which could result in sub-optimal outcomes… ▪ Transend is unable to deliver the entire capex program. The ACCC in previous decisions has expressed concern over the growing likelihood that TNSPs may be unable to deliver their proposed capex programs. Currently a number of TNSPs and DSNPs have begun or are planning major increases in capex. This is likely to increase competition for limited resources, particularly	▪ It is incorrect to assert that paying a premium for expertise to complete the large capital expenditure program is "sub-optimal". The consequence of reducing capital expenditure to avoid paying a premium is that customers enjoy a less reliable transmission network. The consequences of this approach may far outweigh the costs of the premium. Recent international experience has highlighted the costs of an unreliable electricity supply. ▪ In any event, Transend has not factored a premium into its capital expenditure forecasts to reflect a possible shortage of resources. Therefore, the concern raised by the Commission is purely hypothetical.

No.	Reference draft decision	Reference / quote	Comments / Suggestions
		experienced service providers, major plant items and project management personnel. This issue is also evident in Tasmania, where Transend will need to compete for such resources with Basslink and new generation developments. ▪ Transend delivers the program, but in doing so pays a premium to obtain the necessary expertise and resources. The ACCC would be concerned if this scenario eventuated."	
	page 45	"The ACCC disagrees with Transend's approach for the following reasons… ▪ Pass-through of capex (which can be material) goes against the philosophy of a revenue cap, whereby the ACCC approves a fixed allowance over the regulatory period. Indeed, it would represent a move away from the ACCC's current incentive-based regime towards a cost-plus regime.	▪ This statement is inconsistent with the Draft Decision's comments in relation to clawback. ▪ Further, there are incentive disciplines in the structure proposed by Transend for variable projects in that they must pass the regulatory test or be subject to a connection agreement, and they are subject to optimisation.
	page 45	"The ACCC disagrees with Transend's approach for the following reasons… ▪ It removes the incentive for TNSPs to plan ahead and estimate a complete set of projects over the regulatory period, which forces them to prioritise and optimise capex at the planning stage.	▪ Many projects cannot be estimated at the beginning of the period, or are outside the control of the TNSP. ▪ The probabilistic approach, favoured by the Commission, does not present a complete set of projects. ▪ Note: One of the Commission's 'three pillars' of the capex process is optimisation risk. Transend therefore has incentives to 'optimise' capex under any capex approach. ▪ The Commission's alternative capex approach does not address this concern.
	page 45	"The ACCC disagrees with Transend's approach for the following reasons… ▪ A comprehensive plan of capex at the beginning of the regulatory period also gives interested parties valuable information, enabling them to comment effectively.	▪ Transend included information on all its fixed and known variable capex projects in its revenue cap application. Parties were able to comment on these. ▪ The regulatory test mechanism also provides similar information to third parties, at the time the project is being considered. ▪ The Commission's alternative capex approach does not address this concern.

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	page 45	"The ACCC disagrees with Transend's approach for the following reasons… ▪ It transfers additional risk from Transend to its customers, who could be exposed to increases in charges that they cannot anticipate.	▪ Assuming that the Commission adopts a symmetrical approach to 'clawback' as proposed in the Draft Decision, Transend's proposal exposes the company to more risk, not less.
	page 45	"The ACCC disagrees with Transend's approach for the following reasons… ▪ It would require an annual review of actual expenditure and adjustments to be made to the revenue cap, which goes against the principle of light-handed regulation.	▪ The level of annual review, if any, would be a matter for the ACCC to determine. This is the practice in Tasmania at present. It is also potentially the case with other forms of pass-through (eg insurance). ▪ The ACCC's alternative capex approach does not address this concern.
	page 45	"The ACCC disagrees with Transend's approach for the following reasons… ▪ The code is quite restrictive in terms of pass-throughs, although such an arrangement could be accommodated under the TEC.	▪ The ACCC has allowed pass-throughs in its previous decisions, including the draft for Transend. ▪ The ACCC's alternative capex approach does not address this concern.
	page 45	"The ACCC disagrees with Transend's approach for the following reasons… ▪ It is inconsistent with the probabilistic approach [1], which the ACCC has used the in its past three revenue cap decisions.	▪ Transend has used the probabilistic approach in its proposal. In any event, the fact that the Commission has used one particular approach in recent determinations does not necessarily require it to adopt the same approach in future decisions. ▪ The objective of consistency must be balanced with other objectives that relate specifically to Transend's revenue cap application.

[1] The probabilistic approach uses expected values (cost of the project multiplied by probability of it proceeding within the regulatory period) to forecast capex requirements.

Errors?

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	page 5	"The renewals category accounts for about 60 per cent of Transend's fixed capex proposal. There is insufficient evidence to support this large increase."	▪ Transend provided extensive evidence to GHD to support this program. GHD noted that the program is technically justified. ▪ GHD noted that the program would be larger still if it were age-based.
	page 35	***Substation costs*** "Transend did not provide the documentation showing the drivers for items in the replacement program for 110kV circuit breakers. However, GHD considers that age, and not condition, has been adopted as the primary driver."	▪ This is incorrect. Transend has provided this information and is happy to provide it again.
	page 43	"Transend considers that the 'cost-risk trade-off' and 'budget rationalisation involving customers' advocated by GHD were unusual processes."	▪ Transend's quote has been taken out of context.
	page 34	"Transend has not considered providing alternative levels of service, in conjunction with stakeholders, to create a rational basis for deciding trade-offs between cost, timing and risk"	▪ Transend has had numerous discussions with stakeholders regarding its proposed options and meets regularly with Aurora Distribution to discuss their needs. ▪ Transend has not renewed assets where customers have agreed to lower service levels and formulated asset management strategies based on customer needs (eg Wesley Vale substation, Que substation). Each capex project must consider alternative options. ▪ Obsolescence and compliance issues drive much of Transend's capex.
	page 49	"In making its decision the ACCC emphasises that: ▪ Transend must apply the regulatory test or abide by OTTER's planning requirements for each project to justify its inclusion in the RAB"	▪ Transend is not required to apply the regulatory test for renewals. Even the SORP Discussion Paper which suggests use of this test, does not mandate it.

External renewals review

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	pages 5-6 page 46	"Given the large size of the capex, the ACCC would like to flag the following. ▪ Currently renewal expenditure, unlike augmentations, does not have to undergo external review (e.g. regulatory test). However, given the size of the renewals program, the ACCC considers that Transend should be required to demonstrate that its renewal expenditures are economically justified and that there are no better alternatives. It considers that the jurisdictional regulator's interests in Transend's asset management could be expanded to allow for such a process."	▪ Transend rejects the suggestion that imposition of an additional level of review will deliver more efficient capital outcomes. ▪ Transend considers that the RNPP process has merit for major development projects (such as those categorised as 'large' under the Code). ▪ Renewal capex is already subject to internal review and must be assessed for prudency by the ACCC at the end of the regulatory period. ▪ Transend has existing connection agreements with customers, to deliver particular levels of service. It is therefore not appropriate for the RNPP to interfere with the renewals process, particularly for connection assets. ▪ Transend does not believe that the introduction of more heavy-handed regulation for renewal capex is in the interests of any stakeholder.

Under-recovery of capital returns in 2003

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	page 46	"If the ACCC also provides the additional return on capital and return of capital for 2003, it will, in effect, be reversing the effect of the Tasmanian government's policy decision."	▪ Under-recovery of Transend's prudent capital expenditure was an unintended consequence of the roll-forward. ▪ Andrew Reeves, in his August 2003 letter to the ACCC, noted that an adjustment for actual capital expenditure should be made: "The approach at the jurisdictional level has been that the intention was to 'roll over' the existing determination with no clawback involved**, other than the usual adjustments made for actual capital expenditure relative to the forecast capital program** of the electricity entities [emphasis added]."

Asset base

Acquisition costs

	Reference draft decision	Reference / quote	Comments / Suggestions
	page 3	"The ACCC is particularly concerned with the valuation of easement acquisition costs. In its Victorian and South Australian decisions the ACCC did not allow claims for such costs."	▪ Transmission line route (or easement) acquisition costs include those transmission line costs associated with route selection; environmental impact studies; cultural heritage/native title assessments; public consultation and acquisition of easements (excluding compensation payments). These are valid costs associated with constructing (and therefore valuing) a transmission line and were not included elsewhere in SKM's asset valuation. ▪ Transend considers that easement acquisition costs should be valued in accordance with the Depreciated Optimised Replacement Cost methodology used for other transmission assets, and that the Minister's value for Transend's easement acquisition costs is appropriate.

Full depreciation of assets

	Reference draft decision	Reference / quote	Comments / Suggestions
	page 26	"The ACCC understands that Transend never fully depreciates its transmission assets. Transend stops depreciating them when the assets reach a remaining life of five years."	▪ Note: Transend intends to cease this practice in the forthcoming regulatory period, to better align with the ACCC's post-tax revenue model and accounting practice. ▪ Depreciation allowances in the forthcoming regulatory period therefore allow for some assets to be fully depreciated by June 2009.

Interest During Construction (IDC)

	Reference draft decision	Reference / quote	Comments / Suggestions
	page 26	"The ACCC's concern is that the one project selected by SKM may not be representative of the IDC."	▪ This issue has not previously been raised with Transend. ▪ Further information to support the use of the IDC rate was provided to Meritec. ▪ Should the ACCC require it, further information can be provided to the ACCC to substantiate the IDC rate used.

Opex comments

GHD's analysis

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	58, 59	The ACCC have referenced MEG's concern, "that choosing 2001-02 would advantage Transend, as it would have deferred expenses to later years of the current regulatory period. It suggests using an average over the current regulatory period would be more appropriate" (page 59). The ACCC note: "The ACCC also agrees that regulated firms have an incentive to increase their expenditure towards the latter years of the regulatory period with the expectation that this expenditure will be used to determine allowances for the next period. To some extent, however, GHD's choice of base year overcomes this distortion as it is not the last year of the previous regulatory period".	▪ This concern would only be legitimate if the Commission had outlined in advance that future operating expenditure allowances would be based on the actual expenditure incurred in the later years of the current regulatory period. As Transend has consistently argued that the Commission should look forward to the company's future requirements, and rely on historic expenditure as a guide, MEG's concerns are ill-founded. ▪ The ACCC's statement implies that Transend may have deliberately distorted its opex expenditure 2002-03 to achieve higher future returns. There is no factual basis for this suggestion, and it is not supported by GHD's report.
	65	"The ACCC also notes that the full costs estimated by Transend for activities relating to NEM-entry and participation, increased maintenance and telecommunication costs, have been included by GHD in its recommended opex."	▪ This statement is incorrect. Transend has identified a substantial gap between GHD's narrative and its conclusions. It has not been possible for Transend to determine why this gap exists, but one likely explanation is that the full costs of NEM-entry and participation (including indirect costs) have not in fact been allowed.
	65	"Transend's scope of work may have increased. However, the ACCC considers that this could have been at the expense of some of Transend's usual work. For example, the ACCC understands that resources required for the TWEM project have been drawn from other areas within the business. Also Transend was unable to deliver its planned capex program. As such it is unclear whether or not the increase in scope was offset by a reduction in output in some normal activities (substitution effect). Hence it is difficult to establish whether management induced efficiency	▪ This supports Transend's case for opex. The Commission is arguing that an efficiency bonus should not be allowed on the basis that Transend has diverted resources away from its normal activities to address scope increases. If this argument is correct, then Transend's current level of operating expenditure does not reflect the full scope of Transend's existing tasks. On this basis, using 2001/02 operating expenditure as the starting point for a trend analysis will provide insufficient revenue in the first year, and every subsequent year. ▪ It seems that the Commission is employing one argument to remove the case for an efficiency bonus (ie that current scope is not being fully met by 2001/02 operating expenditure), and a contradictory argument when setting future operating expenditure (ie that current scope <u>is</u> being fully met by 2001/02

No.	Reference draft decision	Reference / quote	Comments / Suggestions
		gains were actually achieved."	expenditure).
	58	Section 5.6 in the ACCC's Draft Decision titled: *"Submissions by interested parties and Transend on GHD's opex report"*	▪ The ACCC has included only one of Transend's comments on the GHD report, relating to the System Controller function. All other comments raised by Transend in two submissions on the GHD report have not been referenced or addressed in this section. Transend does not consider this to be acceptable, particularly given the seriousness of Transend's comments and the weight given by the ACCC to GHD's report.

Efficiency factor

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	65	"The ACCC accepts the two percent efficiency factor on the base level opex commencing in 2003-04, as recommended by GHD. The ACCC notes that in the past, OTTER has applied an efficiency factor of comparable magnitude in its regulatory decision."	▪ OTTER's efficiency factor has not been achievable. It is therefore inappropriate for the Commission to use OTTER's previous determination as reason to impose an efficiency factor in the next regulatory period. A better analysis is that no other TNSP regulated by the Commission has had an efficiency factor imposed on them.
	65	"The ACCC also considers that the large renewals program should result in some opex efficiencies."	▪ Transend's works plans already factored in opex reductions due to the capex plan. Transend's works plans are at a detailed, asset-by-asset level. ▪ The ACCC has cut the renewals program. If Transend were to follow the ACCC's capex recommendation, this would lead to *increased* opex relative to Transend's expenditure plans.
	36 (capex chapter)	"GHD disallowed the [capital] expenditure for standards and procedures and some contingency items as efficiencies generated from adopting them should more than offset their costs."	▪ It does not seem appropriate to disallow capital expenditure on the basis that it will deliver operating expenditure efficiencies, if these operating efficiencies are being passed through to customers in the form of a 2% efficiency dividend.

Benchmarking

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	8 and 9	"The ACCC considers that opex as a proportion of asset base and opex per unit of circuit length, while having some limitations, are more useful than the other ratios. Figures 1.1 and 1.2 show these two ratios for TNSPs."	▪ The Draft Decision does not justify this view. ▪ In addition, the benchmarking analysis does not demonstrate that Transend's operating expenditure forecast in the revenue application is unreasonable. On the contrary, if proper account is taken of economies of scale, the benchmarking analysis would show that Transend's revenue application is not unreasonable.
	56	"GHD notes that in several reports opex benchmarks showed Transend as a lower to middle cost TNSP in Australia, during 1999-00 or 2001-02. However, if the opex figures from Transend's application are incorporated, its relative position compared to other TNSPs would worsen for the period to 2005-06 before stabilising in later years as one of the higher cost TNSPs."	▪ Figures are not presently available for all TNSPs for later years. ▪ Given its lack of economies of scale, Transend would be expected to be a higher cost performer on many of the measures. This does not mean Transend is inefficient.

Errors?

No.	Reference draft decision	Reference / quote	Comments / Suggestions
	Page 8	"Transend could not substantiate how future cost efficiencies had been built into forecasts"	▪ Transend has provided GHD and the ACCC with information regarding cost-efficiencies factored into the opex forecast. Transend's expenditure plans have been developed on an efficient basis by: ▪ 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

No.	Reference draft decision	Reference / quote	Comments / Suggestions
			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.
	Page 8	"Transend has several concerns with GHD's trend analysis, mainly that the recommendation to reduce its total claim by $35m over the regulatory period was unattainable without compromising service levels."	▪ While this is certainly a fundamental concern, Transend's concerns are broader than this, and relate to the disparity in GHD's opex report. See our submissions.
	8	"Transend considers that its proposed opex increase is justified, as its operating environment will change considerably after NEM-entry."	▪ Transend has also noted the extensive changes over the present regulatory period – which shows that current levels are still insufficient before NEM entry. ACCC appear to accept this in their commentary on Transend's proposal for an opex efficiency bonus.
	10	"The ACCC agrees with Transend that its operational environment will change during the forthcoming regulatory period, as Tasmania enters the NEM. However, it considers that Transend's core business will not change substantially."	▪ The scope and costs of undertaking Transend's core business are increasing, and present resourcing levels are not sufficient (see ACCC comments on efficiency gain).
	54	"Transend further notes the ACCC has argued that total opex to line length is a more useful ratio than some other ratios as it considers that most of its expenditure is incurred in maintaining substations rather than lines."	▪ Sentence appears to have words missing. ▪ Perhaps re-draft as follows: ▪ Transend further notes the ACCC has argued that total opex to line length is a more useful ratio than some other ratios. Transend does not consider this holds for its business, as most of Transend's expenditure is incurred in maintaining substations rather than lines.