



Mr Sebastian Roberts
General Manager
Regulatory Affairs - Electricity
Australian Competition and Consumer Commission

By email

29 January 2004

Dear Sebastian

Post tax revenue model

Transend welcomes the Australian Competition and Consumer Commission's decision to publish its post tax revenue model, and to invite comments from interested parties. This is a very positive step forward in terms of enhancing the transparency of the regulatory process.

Although Transend has not thoroughly examined all aspects of the model, our preliminary view is that the present value of the revenue and cost streams appear to match one another. In our view, this is the critical test of any model. Other issues of model design, such as whether cash flows are expressed in pre- or post-tax terms or the profiling of depreciation, are of secondary concern. In making this comment, we note that there are numerous ways of modelling revenue requirements – each valid method should provide the same outcomes in present value terms and should also be transparent regarding the techniques used.

However, Transend does have one concern with regard to the costs allowed for interest during construction (IDC). In its handbook the ACCC on page 14 states that:

The capex data includes an allowance for interest during construction; that is, the cost to the TNSP of procuring finance during the construction phase of an investment project. This is calculated at being half the vanilla WACC. As the ACCC assumes that the commissioning date for investment projects is spread evenly over the year, providing half vanilla WACC on the cost of capital projects adequately compensates the TNSP.

In Transend's view, the model does not explicitly allow for IDC in the way that the ACCC suggests. Allowing half the vanilla WACC reflects only the assumption that capital commissioning takes places evenly throughout the year – it does not include

the financing costs associated with bringing the asset to service.

The inclusion of a financing cost should recognise that there is a time-value-of-money-related cost associated with expending funds on an asset over a prolonged period. During this period the providers of finance (ie lenders and equity holders) require a return on their investment, even though the asset is still under construction, and not yet included in the asset base, and therefore not producing any cash inflow.

Transmission capital project lead times often include engineering studies; achieving planning and regulatory approvals; public consultation; contractual arrangements; designing; constructing and commissioning an asset. Transmission project lead-times therefore regularly take in excess of 18 months.

In our view, the ACCC's model intends only to roll assets into the asset base once service delivery commences. Under this approach, the capital cost rolled into the asset base should include IDC during the construction phase. The half vanilla WACC allowance does not recognise this cost, and therefore understates the revenue requirement.

An alternative approach to recognising the IDC during the construction phase is to allow assets to be rolled into the asset base as expenditure is incurred. Essentially, this type of "spend model" would mean that the TNSP does not incur financing costs in constructing the asset. In present value terms, customers (and the TNSP) would be indifferent between a "spend model" and a "in-service model". Unfortunately, the ACCC's model is in error because it provides a lower revenue stream than either approach properly implemented.

It is also worth noting, for completeness, that the appropriate cost of capital for IDC is the pre-tax WACC rather than the vanilla WACC.

Transend recommends that the ACCC clarifies the treatment of IDC as it works towards finalising the model. We would be pleased to discuss the issues raised in this submission if the Commission would find that helpful.

Yours sincerely

[by email]

Bess Ramsay
Analyst – ESI Regulation and Compliance