TRANSEND

TRANSEND SUBMISSION ON ACCC'S DRAFT DECISION ON THE STATEMENT OF REGULATORY PRINCIPLES

November 2004

D04/28911 - FINAL

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1 INTRODUCTION

1.1 DRAFT STATEMENT OF REGULATORY PRINCIPLES

Transend Networks Pty Ltd (Transend) welcomes the opportunity to comment on the Commission's two draft decision documents:

- the *Draft Statement of Principles for the Regulation of Electricity Transmission Revenues – Background Paper* (draft background paper); and
- *the Draft Statement of Principles for the Regulation of Electricity Transmission Revenues* which is a consolidated version of the revised regulatory principles set out at the end of each chapter of the draft background paper (the draft rules).

This submission commences with a summary of Transend's views on the draft decision. The remainder of this submission examines the draft decision in more detail. For ease of reference, we follow the same structure as the Commission's draft background paper. Transend would welcome further discussion with the Commission or interested parties to clarify any of the comments made in this submission.

1.2 SUMMARY OF TRANSEND'S VIEWS

Transend summarises its principal views as follows:

(a) In many areas the Commission's draft decision represents a significant improvement on the earlier discussion paper in terms of internal consistency and clarity.

(b) Transend welcomes the Commission's efforts to provide an overview of the regulatory framework, and the Commission's recognition that the framework must be considered as a whole, rather than in terms of its individual components.

(c) Transend particularly welcomes the Commission's initiatives in providing more certainty with regard to future asset base valuations, cost of capital decisions and information requirements.

(d) It is encouraging that the Commission is considering approaches to improve the incentives on TNSPs to deliver service and cost efficiencies, in the interest of achieving more light-handed regulation. However, Transend considers that the Commission's present interpretation of the DRP's ex-post capital expenditure (capex) incentive framework is inconsistent with the DRP.

(e) The proposal to provide TNSPs with a copy of their revenue model is positive. Transend suggests that this model be published and form part of the revenue cap decision.

(f) Transend is concerned by the Commission's proposal to publish all documents (presumably inclusive of a large volume of detailed supporting documentation) relating to the revenue-setting process.

(g) The detailed mechanism for roll-forward of the asset base, including the application of efficiency payments, is not entirely clear. Transend believes that actual depreciation should be used to roll-forward the regulatory asset base.

(h) The Commission would further enhance the clarity of its position on a number of matters by setting out its approach in spreadsheet format. In particular, roll-forward under the ex-ante and ex-post arrangements, and calculation and treatment of operating and capital efficiency bonuses/penalties would be of benefit. This would reduce the scope for different interpretations of the Commission's position. The models should also illustrate how the proposed regime would be integrated into the Commission's existing post-tax revenue model (used to calculate the revenue allowances) and the regulatory accounting pro-formas (used to track annual performance). A range of different scenarios should be covered by these models (for example, capital over-spend, under-spend, same total spend but different profile).

(i) Transend does not support a firm ex-ante *cap*. Transend considers that an ex-ante *allowance* provides a better mix of incentives for customers and Transmission Network Service Providers (TNSPs). In addition, the proposed 'excluded' project and 'off-ramp' frameworks appear unnecessarily prescriptive.

(j) If the building blocks are to be set appropriately, Transend considers that it is important to define 'regulated revenue'. The draft decision concentrates on the costs of providing regulated or 'non-contestable' services, without adequately defining these services. Transend has prepared a separate paper on this matter (titled Transend submission on ACCC's Draft Decision on the Statement of Regulatory Principles – Excluded Services Proposal), which is attached as a separate paper to complement this submission.

(k) The draft decision has not covered the issue of regulatory test thresholds for large and small projects. The review of the regulatory test held earlier in 2004 stated that this issue would be addressed in the SRP process.

(l) The Commission should explain its forecasting and modelling approach to capital 'as-spent' versus 'in-service'. Transend seeks assurance that the Commission's modelling ensures that there is no penalty for adopting a particular methodology, for example by recognising finance during construction if an 'in-service' model is used.

(m) The Commission should identify how its model will deal with timing lags associated with setting revenue caps.

(n) It is unfortunate that the Commission has two documents setting out its 'draft' regulatory principles – one dating back to May 1999. The draft decision still (somewhat selectively) references aspects of the previous draft and updates other aspects. The Commission should ideally produce a single document that reflects the Commission's consolidated thinking.

(o) It is unsatisfactory that the 'draft regulatory principles' produced in May 1999 is now out-of-step with the Commission's regulatory practice. Transend repeats its previously stated view that the Commission should adopt a clear process for updating its statement of regulatory principles. In addition, in each revenue cap decision, the Commission should provide a detailed explanation where its approach differs from that described in the statement of regulatory principles, and should clearly state the reasons for any divergence.

(p) It is encouraging that the Commission has been prepared to consult widely on the draft decision. It may be helpful if the Commission were to develop Question and Answer sheets to distribute to provide responses to common questions asked during the consultation process.

As noted above, the proposed framework lacks clarity in some areas, which raises the possibility of significant differences between the draft and final decisions. For this reason, and given the significance of this decision, it may be appropriate for the Commission to take the unusual step of issuing a revised draft statement prior to reaching a final decision. A further (shorter) round of consultation could then be undertaken before the draft decision is finalised. While this will extend the consultative process beyond the original timetable, it has the advantage that any relatively new concepts or positions will be further tested before being incorporated in the final decision.

1.3 EX-POST REGULATORY INCENTIVE FRAMEWORK

Overall, Transend supports much of the Commission's analysis and discussion presented in section 2 of the draft background paper. However, Transend remains concerned that the Commission appears to have conflicting views regarding the incentive properties of the framework established by the draft regulatory principles (DRP) in May 1999. Specifically, we draw the Commission attention to the following three statements from the DRP (May 1999); and the draft background paper (August 2004);

DRP pages 36, page 56 and 97 (May 1999):

Statement 1:

"The Commission does not favour a framework that claws back past revenues."

Statement 2:

"It is to be noted that the forecast basis for asset inclusion provides an incentive encouraging the entity to inflate its capital expenditure forecasts. This is because the TNSP gets to keep the return on the difference between forecast and actual expenditure." - emphasis added

Statement 3:

"Benefits will be glide pathed for a five year period commencing at the start of each regulatory review.

The Commission will make the following adjustments at the end of each regulatory period, to apply in the next regulatory period:

- Rate of return – full P0 adjustment;
- Operations and maintenance expenditure – straight line glide path over the next regulatory period; and
- Capital expenditure – full P0 adjustment. The TNSP is invited to demonstrate in its regulatory review application that any capital expenditure below forecast levels over the previous regulatory period has arisen because of management induced efficiency gains.

  Where it is clearly demonstrated by the TNSP that capital expenditure shortfalls are the result of management efficiencies or innovation, the capital expenditure efficiency gains may be subject to a glide path. If the regulated TNSP does not clearly demonstrate the case for retaining efficiency gains, then a full P0 adjustment may be made on the capital expenditure component of cost savings.

Forecast depreciation allowances linked to capital expenditures which do not eventuate are to be assigned to existing assets on a pro-rata basis: reducing the regulatory asset base at the beginning of the next regulatory period.

Sharing is not asymmetric, and the glide path and P0 adjustments outlined above will apply equally in the situation where there are losses."

Draft background paper, pages vi and 73 (August 2004):

"What currently exists is in effect a rate of return approach where the costs of investment are included following an ex-post assessment of the efficiency of the investment."

"Under this ex-post approach (that is, the assessment occurs at the next revenue cap reset after the TNSP has already incurred the expenditure):

- capital expenditure within the allowance may still be excluded from the opening RAB at the revenue cap reset
- capital expenditure that exceeds the allowance may still be included in the opening RAB at the revenue cap reset

any excess return and depreciation associated with forecast capex that did not eventuate is recovered at the revenue cap reset." emphasis added

These two sets of statements (one set from the DRP and one from the Draft SRP) – both purporting to describe the existing arrangements – are contradictory. As far as we can tell, the Commission has unwittingly moved away from its own DRP framework.

Transend is concerned that the Commission's current intentions (which, in this case, is to 'clawback' capital underspend) appear out-of-step with the DRP. Further, the draft decision does not provide any comfort that a process has been developed for ensuring that:

(a) revenue decisions are consistent with the statement of regulatory principles; and

(b) the statement of regulatory principles is regularly updated to reflect current regulatory practice.

Transend would appreciate the Commission having a closer look at this 'clawback' issue in its final decision to ensure that descriptions of the DRP are accurate. In addition, the Commission should introduce arrangements for ensuring that the regulatory principles are consistent with regulatory practice.

On a more minor matter, Transend does not support the Commission's view on page 14 of the draft background paper that:

> "One of the fundamental principles of economic regulation is that the (marginal) price paid for a service should, as far as possible, be equal to the marginal cost of providing that service."

As far as Transend is aware, this is not a principle of economic regulation. Marginal cost pricing is not relevant to setting the building blocks, although it is relevant to network pricing. Whilst a relatively minor point in terms of the overall document, it is worthwhile correcting this statement.

2 REVENUE CAP DECISION MAKING PROCESS

2.1 CONFIDENTIALITY

In relation to confidentiality, the Commission states (page 51, draft background paper) that all submissions and other documents (except those containing information provided by a TNSP under clause 6.2.5 of the code) will be treated as public documents and placed on the public register unless otherwise requested. If a party wishes to claim confidentiality with respect to all or part of a document, the party must:

- clearly identify the information that is the subject of the confidentiality claim;
- where only part of a document is confidential, provide a non-confidential version of the document for the Commission's public register. (This version must clearly indicate where information has been deleted due to confidentiality); and
- set out the reasons in support of the confidentiality claim.

Transend supports the principle of maximising the transparency of the regulatory process and the availability of documents to interested parties. However, from a practical perspective, working papers, emails and other correspondence between a TNSP and the Commission's consultants should not be subject to public disclosure. Instead, it is better to rely on robust consultants' reports to provide analysis of the information in the context of their terms of reference, rather than subject each document provided to the Commission and its consultants to public scrutiny.

Transend supports Powerlink's views on confidentiality, as expressed in its submission to the Commission's discussion paper on regulatory principles. In particular, Powerlink argued that there are numerous reasons why some TNSP data should be treated confidentially by the Commission during the revenue resetting process, namely:

- Commercial information related to purchasing a service from a supplier could be used by the supplier to affect the price that they would otherwise bid for goods or services. This could be to the detriment of consumers.
- Conditions of contract.

- Data pertaining to staff costs could be contentious.

Transend supports Powerlink's view that:

- Information should be made available to the market for a 'reasonableness check' of the TNSP's forecasts and for affected participants to understand the impact of the forecasts on them. For these purposes, data can be aggregated and summarised at a reasonably high level so as not to jeopardise confidentiality.
- Information should be made available to the Commission and its consultants to carry out a more detailed analysis of the TNSP's forecasts. For these purposes, information will be required in a level of detail appropriate for the building block being considered. In some cases where it is appropriate to apply a more light-handed approach to a building block, high level information may be all that is required.

Transend also considers that more than 'confidentiality' issues may arise from the publication of internal documentation. Internal documentation outlines document templates, systems, plans, policies and procedures which are part of an organisation's intellectual property. While the underlying data may not always be confidential, the TNSP may not wish to share this intellectual property with the market at large. Transend therefore suggests that the Commission reconsider its position that "all submissions and other documents" be placed on the public register.

2.2 PUBLIC FORUM

The format of the public forum is that interested parties make presentations on particular aspects of the Commission's draft decision. There is limited interaction between presenters, and no active participation from the Commission on the issues raised.

Transend recognises that the Commission must be careful not to make decisions 'on the run' during public forums, and must be relatively guarded in the comments that it makes. However, the value of these public forums would be greatly enhanced for all parties if the Commission were more prepared to make presentations and enter into discussion on the issues raised. Such participation would also give confidence to interested parties that the Commission is engaged in effective consultation, and will provide better feedback to presenters that the issues have been noted.

2.3 PUBLICATION OF DETERMINATION

2.3.1 Post-tax revenue model

Transend welcomes the Commission's proposal that TNSPs should receive a copy of the financial model used by the Commission to calculate that TNSP's revenue cap (draft background paper, page 47). To the extent that the model is not commercially sensitive, Transend would support the model being available on the Commission's webpage. In addition, it would be beneficial to include the model as part of the revenue cap decision. This will help ensure that the Commission's decision, and its underlying assumptions at the time the decision was made, is not misinterpreted in the future.

2.3.2 Revenue or 'price control' formula

Transend remains concerned that the Commission's revenue cap decisions have not provided details of the revenue control that is to apply. Transend has repeatedly requested that the Commission set out the details of its determination. Specifically, the regulatory framework needs to establish a workable definition of 'regulated revenue' and 'regulated transmission services'. The Commission's approach so far has been to note the Code requirement that the revenue cap only applies to 'non-contestable' services. Unfortunately, such an approach does not provide a workable definition of 'regulated revenue'. Transend notes that it is standard practice for regulators to set out determinations in the form of detailed revenue or 'price control' formulae. Transend's Excluded Services Proposal submission (provided separately), proposes a workable definition of 'regulated revenue' for setting revenue caps.

3 ASSET VALUATION

Transend strongly supports an asset base roll-forward approach rather than an asset base revaluation approach (page 15 of the Draft rules).

To progress this initiative Transend suggests that a National Electricity Code (NEC) change be drafted to provide the details of the asset base 'lock-in' process.

This section of Trasend's submission discusses issues associated with roll-forward of the regulatory asset base (RAB). It includes discussion on depreciation, and the details of roll-forward under the ex-post regime, including Transend's understanding of the present ex-post regime efficiency mechanisms. Details of roll-forward under the ex-ante regime are covered in section 5 below.

3.1 LOCK-IN OF ASSET BASE TO DETERMINE AN OPENING RAB FOR THE REGULATORY PERIOD

The clarity of this section of the draft rules and the corresponding discussion in the draft background paper (page 68) could be improved. The task is complicated because the section deals with the transitional arrangements from the ex-post to ex-ante regimes, in addition to the ex-ante regime itself.

3.2 EX-POST REGIME FRAMEWORK DETAIL

In relation to the ex-post regime, the draft background paper explains (page 68):

> "the ex-post methodology involves a two-step calculation:
>
> Step 1: Calculate the opening RAB on the basis of the forecast capex from the previous regulatory period
>
> Step 2: Adjust the RAB calculated in Step 1 for the difference between the forecast and out-turn (efficient) capex including the foregone return on capital on the difference [footnote: the Commission will adopt the post-tax WACC in rolling forward the carried value of the prudent unforecast capex.]"

This process is not entirely clear. In particular, the 'opening RAB' referred to in Step 1 must reference the RAB established by the Commission in its most recent revenue determination.

In addition, Step 1 makes no reference to depreciation. Transend understands that the roll-forward methodology must include capital additions, disposals and depreciation. It is of some concern that the steps described in the draft background paper and the draft rules are incomplete.

The Commission will need to clarify whether depreciation used in the ex-post roll forward is actual or forecast. The DRP suggests that actual depreciation will be used and pro rated against the closing (actual) RAB. If the Commission intends to use forecast depreciation to roll-forward the asset base (contrary to Transend's suggested approach), Transend would prefer that the reconciliation between allowed and actual depreciation be shown as a line-item adjustment. This would avoid the difficulties associated with arbitrary adjustments (or pro rated increases or decreases) to the actual depreciation applied to individual asset classes.

In terms of the transition from the ex-post to the ex-ante cap regime, Transend believes the process should be as follows:

Step 1:

- Take the opening RAB agreed by the Commission used in the most recent revenue cap decision (eg for Transend this would be the opening RAB at 30 June 2003, as the following 6 months were a forecast only).

- Add the forecast capital additions and subtract the forecast disposals and forecast depreciation (all expressed in constant dollars)

  (eg for Transend this would be the capex, disposals and depreciation modelled by the Commission in their 2004 to 2008/09 revenue cap decision).

This is the 'forecast closing RAB' for the most recent revenue period.

Step 2:

- Take the opening RAB used in the most recent revenue cap decision (eg for Transend this would be the opening RAB at 30 June 2003).
- Add the actual capital additions and actual disposals and actual depreciation (all expressed in constant dollars). *Note: at the time the revenue cap application was submitted, figures for the last two years of the revenue period will be forecast only. One of these year's figures will be finalised during the review period.*

This is the 'actual closing RAB' for the most recent revenue period, which should be the same as the 'opening RAB' for the forthcoming regulatory period, provided that the Commission considers all the additions to be prudent.

Step 3:

- Compare the difference between the forecast additions, disposals and depreciation.
- Include an adjustment to the returns required for the forthcoming regulatory period, based on the following:
  - Whether a depreciation allowance adjustment is required to reflect a difference between actual and forecast depreciation (see section 5 below).
  - If the TNSP has prudently over-spent its capex, then also allow an adjustment for the foregone return on capital, which is to be included in the forthcoming regulatory period.

This will input to the revenue cap for the forthcoming regulatory period.

If the Commission considers that the TNSP has not incurred capital expenditure wisely, and consequently makes a downward adjustment to a capital addition, then the Commission will need to consider how this will be treated for regulatory asset base, revenue setting and pricing purposes.

3.3 EX-POST CARRY-OVER MECHANISM

Transend notes that the DRP (statement 7.2) provides for a glide-pathing of demonstrated capital efficiencies. The objectives of 'glide-pathing' are similar to those of the efficiency carry-forward mechanism, which the Commission is now proposing to formalise in relation to operating expenditure. The draft decision, however, does not appear to contemplate an efficiency carry-forward mechanism for capital expenditure. Transend is unsure whether this is an oversight or whether the Commission has departed intentionally from the DRP on this issue.

4 INCENTIVE FRAMEWORK FOR CAPITAL EXPENDITURE

This section of Transend's submission relates to the incentive framework under an ex-ante capital framework. The proposed capital framework involves the Commission's greatest departure from the present DRP arrangements.

The draft decision makes a number of useful observations regarding the capital expenditure framework. Transend is pleased that the Commission now appears to accept that the regulatory test will not always provide a definitive assessment of the prudency of actual capital spend on a project (for example, see page 73 of the draft background paper).

4.1 FIRM EX-ANTE CAP

Transend is extremely concerned by the Commission's proposal to only roll in the lesser of the actual capital expenditure or the capped level of investment. Such a proposal would mean that prudent capital over-spend will not be remunerated *at all* under the Commission's proposed regime. This provides a very powerful incentive not to exceed the ex-ante cap, even if there are customer benefits in doing so. This may lead to inefficient outcomes.

Transend recognises that the Commission is proposing that

(i) the ex-ante cap may be dynamically adjusted (for example, in response to load growth);

(ii) there may be provision for excluded projects and off-ramps in addition to the ex-ante cap; and

(iii) the Commission considers it will need to be 'conservative' – where a conservative cap means a high cap – in setting the ex-ante capex allowance, so that TNSPs are not penalised by an unduly onerous cap (page 84, confirmed by further discussion with the Commission).

While this seems a reasonable package in theory, Transend considers that it poses significant risks in practice. The greatest risk is that the ex-ante cap will be insufficient.

As Transend noted in its April 2004 submission to the Commission on the Capital Investment Framework, a cap may penalise the TNSP twice. If a TNSP overspends against a fixed ex-ante allowance, then it will suffer a loss of profit within the regulatory period. It is not necessary or appropriate to disallow an appropriate return on this investment in subsequent regulatory periods. The penalty may reflect inappropriate assumptions (made either by the Commission or the TNSP) at the time of the revenue determination, which have no bearing on the prudency of the investment decision. Further, Transend considers that the Commission will be under considerable pressure *not* to set a conservative ex-ante cap. Where the cap is insufficient either the TNSP, or customers, or both, will be penalised.

Transend's recent revenue cap experience showed that the Commission's consultants are prepared to recommend the making of 'subjective' cuts in setting capital allowances, (see page 56, GHD's Consultant Report, Transend Regulatory Review, June 2003) and that the Commission is prepared to make these cuts. In the face of downward-pressure on prices, there is a strong possibility that the Commission will set an ex-ante cap that is insufficient to meet reasonable future capex needs. Transend therefore supports an ex-ante *allowance* where a TNSP may be penalised or rewarded in-period, but not an ex-ante *cap*.

4.2 EX-ANTE CARRY-OVER MECHANISMS

The rationale for an efficiency carry-forward mechanism for capital expenditure is identical to that for operating expenditure. Specifically, the objective is to provide throughout the regulatory period a relatively constant incentive to deliver efficiency gains. Without an efficiency carry-forward mechanism, the incentive to deliver efficiencies towards the end of the regulatory period diminishes, as the shareholder retains a very low share of any efficiency gains.

The calculation of capital expenditure efficiencies is different to operating expenditure. The annualised cost of capital expenditure is the 'return on' and 'return of' capital. These two elements therefore constitute the available efficiency gain that can be shared between the shareholder and the customer.

The Commission is able to devise a carry-forward mechanism that includes either or both the 'return on' and 'return of' capital. The choice depends on the preferred power of the incentive regime. Transend notes that the Commission's approach to capital expenditure is focused on increasing the power of the incentive arrangements. In this regard, Transend notes that the Commission may decide that it is appropriate to include an efficiency carry forward mechanism with regard to capital expenditure.

To reduce confusion Transend suggests that, in constructing the revenue cap building blocks, any capital incentive payments should be listed separately from the capital allowance. Table 1 below illustrates this separate line item.

Table 1

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue Building Blocks					
Forecast Return on Asset	50	60	65	70	75
Forecast Depreciation	25	25	30	30	35
Forecast Opex	30	35	35	32	30
Forecast Net tax allowance	3	3	4	4	4
Base revenue cap	**108**	**123**	**134**	**136**	**144**
Plus (minus) last period depreciation adjustment	-5	-5	-5	-5	-5
Plus Capex incentive payment					
Plus Opex incentive payment					
Net revenue cap	**103**	**118**	**129**	**131**	**139**

Transend's view is that it should not be required to reduce revenue in the next regulatory period if a capital overspend has occurred. The actual capital expenditure should be rolled into the asset base, noting that the TNSP has strong incentives not to overspend and, therefore, the actual capital expenditure is highly likely to be prudent. However, if the Commission decided to introduce a symmetrical carry-over mechanism, Transend would prefer such a symmetrical mechanism to the inappropriate incentives proposed under an ex-ante *cap*.

4.3 CHOICE OF STRENGTH OF INCENTIVE

If the Commission still wishes to explore the application of an ex-ante cap, Transend favours a 'menu approach' whereby TNSPs have some ability to mitigate regulatory risk by choosing between approaches that have different incentive properties. This will allow TNSPs to assess whether or not the Commission has set an ex-ante cap which is sufficient to cover the TNSPs risks. If the cap is sufficient, the TNSP may choose to operate under an ex-ante cap, with harsh penalties for over-spend and rewards for under-spend. If the TNSP does not consider the ex-ante cap to be sufficient to cover their risks, the TNSP should have the option of signing up to a lower-powered scheme (such as those outlined above), where the penalties for over-spend are less harsh, but the rewards for under-spend are less generous.

Transend considers this type of 'menu' approach has the potential to offer benefits for both customers and company.

4.4 EX-ANTE RAB 'ROLL-FORWARD' FRAMEWORK DETAIL

Transend notes that more detail is required to fully explain the detail of the ex-ante framework proposed for the RAB lock-in approach. For example, the draft background paper states,

> "Under the proposed ex-ante framework, the lock-in approach operates as follows:
>
> a) At the beginning of the period the regulator will set a cap on investment over the period of control and choose a level of (forecast) depreciation by a methodology such as straight line depreciation
>
> b) At the end of the regulatory period the regulator will roll in to the RAB the lesser of actual capital expenditure or the capped level of investment. The RAB is then updated using a version of the equation as above." (Draft background paper, page 63)

Transend considers additional clarity would be added if it was explicit in point (a) that the 'cap' on investment may be a dynamically adjusting cap, for example to reflect load growth or peak system demand. As presently drafted, point (a) could be interpreted as being a simple fixed $ amount.

With a dynamically adjusting cap, presumably the depreciation allowance may also be dynamically adjusting. Therefore the allowed depreciation may be a function of a formula, rather than a fixed number. Some simple sample spreadsheets could assist outline how the Commission would manage annual revenue allowances under such a scheme.

4.4.1 Depreciation method

Transend notes that it is not entirely clear whether the Commission intends to use forecast or actual depreciation in its roll-forward of the RAB under the ex-ante regime. Transend supports the use of actual depreciation in the RAB roll-forward.

Transend advocates the use of actual depreciation on the basis that it is consistent with the Commission's information requirements guidelines, which require TNSPs to submit annual regulatory financial accounts that reflect actual depreciation of the asset base (not the Commission's forecast). This may also allow for simpler reconciliation with the statutory financial accounts, as the same depreciation lives may be used for both regulatory and statutory accounting purposes. Transend recognises that the forecast depreciation may need to be compared against the actual when setting the next revenue cap, depending on the incentive mechanism adopted.

Transend's preferred approach in relation to depreciation is as follows:

(iv) For revenue cap-setting purposes forecast capital additions and depreciation are used to roll the RAB forward and project the residual RAB.

(v) For annual regulatory reporting purposes actual capital additions and actual depreciation are used to roll the RAB forward.

(vi) There is value in trying to reconcile the RAB with what actually occurred over a regulatory period, rather than what was predicted to happen. This will better-align with statutory reporting requirements.

(vii) If depreciation does not form part of the incentive regime, the difference in actual versus forecast depreciation values will need to be recovered from (or given back to) customers over time. This may occur over the next regulatory period, over the remaining lives of the underlying assets in the Regulatory Asset Register, or some other way. This will need to be done in a net present value (NPV) neutral way. Transend favours an approach which does not affect the actual RAB roll-forward.

(viii) The remaining lives in the regulatory asset register should be the basis on which revenue cap depreciation claims are made.

(ix) The remaining lives in the regulatory asset register should be an input in the forecasting of replacement capital.

4.4.2 Example

The following example illustrates Transend's proposed approach.

Ignoring the time value of money to simplify the analysis, assume a TNSP was given a regulatory depreciation allowance of $100m over a regulatory period, but actually incurred depreciation of $75m in the same period. In its revenue cap application for the forthcoming regulatory period, the TNSP should forecast its actual likely depreciation (say it is forecast to be $150m). In setting the depreciation component of the revenue cap, the TNSP would then adjust its revenue cap application to reflect the over-recovery of depreciation ($25m) in the previous revenue period. The revenue claim would therefore include a depreciation allowance of:

(i) the forecast $150m actual depreciation,

(ii) minus the $25m over-recovered depreciation in the previous period,

(iii) giving a forecast allowance of $125m in depreciation revenue to be included the revenue cap for the forthcoming regulatory period, made up of the two components: the forecast depreciation and the depreciation adjustment.

(iv) At the next reset, it would be the actual depreciation, compared to the forecast depreciation ($150m) that would be the relevant comparison for any future adjustments.

Table 2 illustrates the revenue claim.

Table 2

	Year 1	Year 2	Year 3	Year 4	Year 5	Period
Revenue Building Blocks						
Forecast Return on Asset	50	60	65	70	75	
Forecast Depreciation	25	25	30	35	35	150
Forecast Opex	30	35	35	32	30	
Forecast Net tax allowance	3	3	4	4	4	
Base revenue cap	**108**	**123**	**134**	**136**	**144**	
Plus (minus) last period depreciation adjustment	-5	-5	-5	-5	-5	-25
Plus Capex incentive payment						
Plus Opex incentive payment						
Net revenue cap	**103**	**118**	**129**	**131**	**139**	

Similarly, a TNSP with actual depreciation that was higher than the Commission's forecast allowance, would be able to claim the under-recovered amount as an adjustment to its future depreciation amount. The RAB would be rolled forward using the higher (actual) depreciation figure.

4.4.3 Depreciating easements

While the Commission has noted issues associated with depreciation of easement acquisition and compensation costs, it has not provided any guidance as to whether or not it proposes to depreciate easements.

There are many components of easement acquisition and compensation costs that are increasing in value far more rapidly than the consumer price index (eg environmental approval costs). These components do not depreciate. However there are other components of the costs associated with procurement of transmission line routes that may not have an indefinite life. For example, if a new transmission line is to be built in an existing easement, new planning and environmental approvals may be required, and new customer and stakeholder consultation must be undertaken.

TNSPs generally have little incentive to relinquish existing easements, as the cost of acquiring new easements may be prohibitive, or not possible at all in some areas (eg transmission lines through national parks or world heritage areas).

Transend considers that easements should not be depreciated, and is not presently depreciating these assets when rolling forward its asset base. However, it seems reasonable that, when an easement is released for some reason (including where a TNSP loses an easement right), the capitalised value of the easement compensation costs, and any associated transmission line route acquisition costs, should be subject to accelerated depreciation (ie be written out of the asset base).

Transend suggests that the final SRP outline the approach to depreciating easement acquisition and compensation costs, when rolling forward the RAB.

4.5 EXCLUDED PROJECTS

Transend considers that the Commission's proposal on excluded projects is too prescriptive and that the proposed incentive regime for these proposals is not closely aligned with the existing post-tax revenue cap model.

In discussions with the Commission, the Commission has indicated that they see that excluded projects would need to be well-defined in advance. Transend considers that there may be a number of projects that could be treated as 'excluded', and which cannot be well-defined at the time a revenue cap application is made. For example, a new load (or expansion of existing load) or generation source that leads to augmentations cannot necessarily be well-defined years ahead of a customer connection request.

Transend also considers the 'expected error' formula, with its 10% threshold, as proposed by the Commission is too prescriptive, and it is not clear exactly how it would work. For example, is the 'allowed revenue' numerator made up of all the projects excluding *all* those claimed for exclusion, or all the projects excluding *just that one* claimed for exclusion? (see draft background paper, page 93).

Transend's view is that a TNSP should propose a set of excluded projects (which may include such broad projects as a new load of XXMW which necessitates network augmentation) and explains the case for the exclusion of these projects. It is accepted that the excluded projects would need to lead to a material deviation from the forecast ex-ante allowance. Transend is pleased that the Commission has accepted that materiality will differ between TNSPs.

Where the Commission has excluded certain projects from the TNSP's ex-ante allowance (for example because the Commission's consultants consider that a project is unlikely to go ahead in the regulatory period), then these projects should also be included in the excluded project category.

It is not clear to Transend that there is an adequate 'safety net' for the TNSP if the Commission decides not to include a particular project, or categories of projects, in the excluded projects, and an omitted project *is* required during the regulatory period.

When an excluded project is commissioned an adjustment should be made for operating and maintenance expenditure. This reflects that most excluded projects will be augmentation projects, which will increase the operating and maintenance effort. To simplify the revenue calculations, this allowance could be expressed as a standard percentage of the excluded project's capitalised value. This opex cost adjustment should be factored into any modifications to the post-tax revenue model used to accommodate excluded projects.

4.6 OFF-RAMPS

The draft decision contains some uncertainty as to the scope of an 'off-ramp' event. In one area it is suggested that the Commission has considered specific, identifiable events, such as unexpected load growth or unexpected location of new generation, constituting an off-ramp event (see page 98). In other areas such events seems to fall under the Commission's definition of 'excluded projects', with off-ramps confined to events of a similar scope to those covered by pass-through rules. There is benefit in creating a consolidated set of rules to deal with both long-term and short term expenditure changes as a result of impacts such as service standard events or force majeure events. The Commission's draft decision already recognises that the present pass-through rules cater for some capital 'off-ramp' events.

Transend welcomes the Commission's suggestion that 'off-ramp' events be defined in consultation with TNSPs at the time of their revenue reset (draft background paper, page 100). Transend considers that to simplify the regulatory framework, the present pass-through rules should be adjusted to cater for both operating and capital expenditure pass-through events. This will simplify the regulatory principles and administrative process, particularly as an event that may trigger a capital ‘off-ramp’ is also likely to trigger an operating cost ‘pass-through’.

4.7 OTHER ISSUES

4.7.1 Annual versus revenue period figures

In establishing an incentive regime Transend is wary of relying too heavily on *annual* out-turns for capital expenditure, particularly where commissioned capital is the basis for the capital forecast. As Transend has noted in previous submissions, commissioning of capital projects is ‘lumpy’. This is particularly true of augmentation projects. If a transmission company is efficient and is able to deliver a transmission project ahead of forecast, which leads to an ‘over-spend’ in that year, then the TNSP should not be penalised for early delivery. Similarly, TNSPs should not be incentivised to delay commissioning of a project to the next financial year, simply to receive an increased ‘under-spend’ incentive payment in a particular year.

In Transend’s view, it is more important to look at the capital commissioned over the whole regulatory period, rather than the year-by-year performance against the target. Transend recommends that the Commission gives this issue further consideration and clarifies its thinking in its final decision.

4.7.2 Capex in-service versus capex spend approach.

The Commission’s capex position discusses ‘capex’ and ‘investment’ but does not explain whether this relates to the actual outlaying of capital monies or the commissioning of capital projects.

The DRP was quite clear that the capital forecasts referred to capital ‘in-service’, as opposed to capital ‘as spent’:

> “Additions to the asset base
>
> The valuation of new capital expenditure is more straightforward. Normally new capital expenditure will be introduced to the regulatory asset base on the basis of actual costs incurred up to the point at which the assets become operational. There seems little point in introducing infrastructure to the asset base until it becomes operational as there are no customers to support associated revenues and the burden would fall to users who are, at least to that stage, not receiving any of the benefits. (page 26, DRP)

The DRP further explained that using an ‘in-service’ model requires TNSPs to be remunerated for the foregone returns (ie the WACC) over the period that capital projects are being developed:

> “This raises the question of how the TNSP should be compensated for expenditure on partially completed assets. One option is to simply add ‘bridging’ finance costs to the eventual value of the asset. However, this may not appropriately compensate for the risks involved. Another option is for <u>expenditures already incurred to be rolled forward with an accumulated rate of return equal to that for operational assets to reflect final cost.</u> <u>The accumulated amount would be the amount added to the regulatory asset base when the assets become operational. This is the approach that the Commission has taken for the *Draft Regulatory Principles*.</u>” (page 26, DRP, <u>emphasis added</u>)

Despite the approach outlined in the DRP, in reviewing the regulatory principles to apply to future revenue caps Transend recognises that the use of capex ‘as-spent’ has many forecasting advantages. As mentioned above, commissioning of some capital projects often involves large lumpy amounts, which can fall in different financial years and significantly affect the post-tax revenue model’s returns and depreciation for a given year.

Most organisations try to align statutory and regulatory accounts and this may require capital to be captured on an ‘in-service’ basis to meet accounting requirements. Transend suggests that the choice of capitalisation approach be given to each TNSP, based on the preferences of the organisation (which may be affected by the financial systems in place). Provided that the Commission adequately accounts for the difference in required finance during construction costs when reviewing the capital inputs, there should be no long-term difference to customers under either approach.

5 INCENTIVE FRAMEWORK FOR OPERATING AND MAINTENANCE EXPENDITURE

In general, Transend supports the Commission's approach to establishing operating expenditure allowances and in providing incentives for efficiency gains through the efficiency carry-over mechanism.

5.1 BENCHMARKING

Transend notes that the Commission is intending to examine the possibility of moving to a benchmark approach in setting operating expenditure allowances (page 108, draft background paper). Transend remains sceptical whether benchmarking can be relied upon for revenue-setting purposes.

It is important that any benchmarking of operating costs takes account of business-specific issues such as economies of scale, contractor environment, the scope of assets comprising the transmission system, historic development of the network and network design standards. To date the Commission's benchmarking has not considered any of these variables.

Transend noted during its revenue cap review that the hydro-based generation in Tasmania makes inter-company transmission benchmarks problematic, as the transmission system was designed for, and must be operated in, an energy-constrained (rather than capacity constrained) generation environment. To date the Commission has shown very little interest in understanding the different operating environment and cost drivers for a hydro-generation-based system compared to a thermal-generation-based system.

Transend is pleased that the Commission has recognised the weaknesses of its present high-level benchmarking, and proposes to undertake more analysis. Transend is keen to participate in the Commission's working group to ensure that the matters affecting its operations are fully considered.

5.2 EFFICIENCY CARRY-OVER

Transend is pleased that the Commission is retaining an opex efficiency incentive mechanism, similar to the glide-path mechanism presently outlined in the DRP. Transend considers that the new carry-over mechanism to be applied is not well-explained in the draft decision. It is presumed that the mechanism is similar to that used by the Victorian Essential Services Commission. Transend agrees with the suggested improvements to defining the efficiency carry-over, as proposed by NERA in their consultants report for TransGrid on this matter. The report, titled Efficiency Carryover mechanism, a report for TransGrid prepared by NERA, September 2004, includes a minor error. On page 4 of NERA's report, the algebra should be corrected to read:

$$\text{Carry forward allowance in year t} = \sum_{t-5}^{t-1} E_t$$

and the words "where t=0 signifies the last year of the previous regulatory period" deleted. Alternatively, if the words "where t=0 signifies the last year of the previous regulatory period" are to remain, then the formula should be:

$$\text{Carry forward allowance in year t} = \sum_{t-4}^{0} E_t$$

Transend is concerned that the Commission plans to carry-over any negative payments. This appears to be a double-penalty. If the operating and maintenance allowance is insufficient, and the TNSP must over-spend then the business will not be remunerated for the over-spend. Further, the TNSP will be penalised in future revenue periods where efficiency gains are realised.

The Commission's intention to carry-over negative payments may reflect a mindset is that TNSPs are 'fat' businesses and that any over-spend of opex must be as a result of inefficiency. Transend is a company that was established in 1998 with 40 staff, which is growing to meet its regulatory and customer requirements, and which is having new obligations imposed on the business as a result of joining the national electricity market. Transend considers that over its present revenue period the Commission has not provided sufficient operating and maintenance allowance to operate the business efficiently and sustainably. Transend sees that a similar risk, where the Commission provides insufficient opex allowance, exists into the future. Transend therefore supports a model where net negative efficiency gains are *not* carried forward.

Transend considers that the Commission's post-tax revenue model should show the opex incentive payments as a separate line item. This will ensure that the Commission is comparing actual opex against the forecast for the period, not the forecast opex including any opex incentive payment. Table 3 illustrates this approach.

Table 3

	Year 1	Year 2	Year 3	Year 4	Year 5	Period
Revenue Building Blocks						
Forecast Return on Asset	50	60	65	70	75	
Forecast Depreciation	25	25	30	30	35	145
Forecast Opex	30	35	35	32	30	
Forecast Net tax allowance	3	3	4	4	4	
Base revenue cap	**108**	**123**	**134**	**136**	**144**	
Plus (minus) last period depreciation adjustment	-5	-5	-5	-5	-5	-25
Plus Capex incentive payment						
Plus Opex incentive payment						
Net revenue cap	**103**	**118**	**129**	**131**	**139**	

5.3 INSURANCE

Transend is pleased that the Commission recognises the complexity of the area of insurance, and the many approaches available to efficiently manage insurance events. Transend considers that TNSPs must be incentivised to choose the correct 'mix' of insurance for their business risk profile.

For example, a TNSP may assess that, based on its risk profile, it is a prudent business decision to have a high deductible and a lower premium for a particular type of event. Such a position may necessitate a pass-through on a small number of occasions when a 'material' event occurs with costs below the deductible level. If the Commission does not allow a TNSP to pass-through the costs of such events, the Commission will send signals to TNSPs to 'insure to the hilt' and pay high premiums with low deductible amounts.

Transend considers that TNSPs must be rewarded for making the best choice between:

- Insurance premiums (with the appropriate level of deductible for the business risk profile) available in the market, with pass-through of the deductible amounts.
- Self-insurance where insurance is not available in the market, or not at commercially viable rates.
- Pass through where insurance is not available in the market, or not at commercially viable rates and where the TNSP is not prepared to self-insure.

- Pass-through where a material insurance event occurs below the deductible limit, or where an event occurs near the deductible limit but where it is more efficient in the long-run to pay this amount than invoke the insurance claim.

Transend requests that the Commission consider these factors, including the treatment of deductibles, when it finalises the next round of pass-through rules. Transend seeks assurance that the Commission will not treat costs associated with deductibles on a different basis to other insurance costs. If these deductible (or below deductible) costs are on a different basis, then the Commission risks distorting the incentive to choose one form of insurance over the other.

6 WEIGHTED AVERAGE COST OF CAPITAL

Transend broadly welcomes the Commission's approach to the weighted average cost of capital. In particular, Transend supports the Commission in adopting:

- the 10-year government bond rate as a proxy for the risk free rate;
- a value of 6 per cent for the market risk premium; and
- an equity beta of 1.0

Transend notes that the Commission reserves the right to keep these parameters under review. Nevertheless, Transend believes that it is an important step forward in clarifying the Commission's approach to the cost of capital – and providing greater certainty to future investors in the transmission network.

7 OTHER ISSUES

7.1 REGULATORY TEST THRESHOLDS

The Commission made the following statements earlier in 2004, when reviewing the Regulatory Test.

> "On the issue of the thresholds for *new small network asset* and *new large network assets*, the ACCC considers that this is best addressed as part of the review of the Statement of Regulatory Principles." (page 4, Review of the Regulatory Test - Decision)
>
> **"3.4.3 New small and new large network asset thresholds**
>
> There is still support for amending the thresholds for *new small network assets* and *new large* network assets. Given that the ACCC is reviewing its approach to setting and approving capital expenditure, it believes that this issue is best addressed as part of its review of the Statement of Regulatory Principles." (pages 31 and 32, Review of the Regulatory Test - Decision)

Despite these statements, the review of regulatory test thresholds appears to have been overlooked in the preparation of the draft decision. Transend urges the Commission to consider this issue and suggests that the Commission consult explicitly on this matter.

7.2 TIMING LAG

The Commission is proposing that TNSPs submit their revenue cap applications by 1 April in the penultimate year of the current revenue cap. Transend supports this timing, although this will mean that TransGrid, EnergyAustralia and Transend will all be submitting their next revenue cap applications in April 2007. The Commission will need to ensure appropriate resourcing to ensure a consistent treatment of these three different companies, with their different operating environments, and scale of operations. This includes consistent analysis by the Commission's consultants, to the extent this is possible.

An issue that will arise with the proposed submission timeframe is that at the time a TNSP is preparing its revenue cap application the company will have only 3 years of full data regarding actual performance relative to forecast performance. During the revenue cap review process another full financial year of data will become available. The Commission will therefore always having to be making forecasts about the likely actual performance relative to forecast for the last year of the previous determination.

This one-year timing lag will persist indefinitely. For example, the following Table 4 indicates two 5-year regulatory cycles. For a revenue cap commencing in 2008-09 the Commission would need to make its decision by March 2008. During the Commission's review, four full years of data will be available for the period 2002-03 to the end of 2005-06, and another year will become available in late 2007 for the 2006-07 financial year. Forecasts will be required for 2007-08 onwards.

Table 4

2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Decision by March	5 year revenue cap period									
Forecast values included in revenue forecast	Actual data available	Actual data available	Actual data available	Actual data becomes available during review (approx Oct)	*Forecast values included in setting revenue cap*					
Suggested forecast v actual figures to be used by ACCC										
					Decision by March	5 year revenue cap period				

Transend suggests that the Commission's revenue-setting consider a proposal whereby the past performance under review is the previous 5 years for which there is full data, or whether adjustment factors are included for forecasts made. This may require some re-thinking of incentive arrangements, as the regulatory period and the incentive period will be one year out. If the Commission does not want to adopt this approach, then Transend seeks further clarity on how the Commission intends to deal with this forecasting issue.

8 CONCLUSION

The Draft SRP contains useful advances in finalising the regulatory principles applicable to TNSPs. However, Transend considers that a number of points of detail require further clarity. Transend would be pleased to work with the Commission and other stakeholders to continue to develop the Commission's post-tax revenue models, to ensure that detail of mechanisms, such as the roll-forward calculation and the modelling framework, are agreed and understood by all affected parties.

The principle of a firm ex-ante cap, with narrowly defined excluded and off-ramp events, poses risks for Transend and customers alike. Transend suggests that there be an ex-ante *allowance*, with actual capital rolled into the RAB. Transend also suggests that excluded events be defined more broadly and that 'off-ramp' events be incorporated in the pass-through rules. Transend has written a supporting paper outlining its proposal for excluding certain types of services in-period from the revenue cap. Transend welcomes further discussion with the Commission on these matters.