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

By email

Dear Sebastian

Draft Decisions for TransGrid and EnergyAustralia

Transend Networks Pty Ptd (Transend) welcomes the opportunity to respond to the Commission's Draft Decisions for TransGrid and EnergyAustralia's revenue caps (the Draft Decisions).

The Draft Decisions raise important matters of regulatory principle, which are likely to have implications for future revenue cap decisions. Transend's submission addresses these points of principle, rather than debating the merits of the Commission's specific pricing proposals for EnergyAustralia and TransGrid. Transend's view is that the Commission's consultants—if properly qualified and resourced—are best placed to examine the proposals presented by the regulated companies and to comment on their reasonableness.

Transend's comments on the two Draft Decisions are attached. This submission is not confidential and may be placed on the Commission's website. I am happy to meet with the Commission to discuss any of the matters raised.

Yours sincerely

[by email]

Bess Ramsay
ESI Regulation and Compliance Manager

ATTACHMENT – TRANSEND COMMENTS ON ENERGYAUSTRALIA AND TRANSGRID DRAFT REVENUE CAP DECISIONS

Transend's submission is organised as follows: comments on specific aspects of the Draft Decisions, followed by general comments on the transparency, consistency and predictability of the Commission's decision-making process. The submission concludes with a consideration of future regulatory developments.

Inappropriate ex post prudency reviews

The most controversial and unexpected aspect of the Draft Decision relates to the Commission's disallowance of capital expenditure from the regulatory asset base for both TransGrid and EnergyAustralia. There are several aspects to this decision which cause concern:

- The Commission and its consultants have been unable to complete its ex post prudency review – and therefore the Draft Decisions remain incomplete in this regard. From the perspective of effective consultation, this situation is far from ideal. Transend is also disappointed that the consultant's starting point is that the project is not prudent until prudency is proved definitively. Transend considers that it is reasonable that capital expenditure be considered prudent unless it can be shown otherwise.
- Despite the Commission's best efforts, it has been unable to determine a prudent level of capital expenditure for the projects that it has examined. As a result, the Commission has imposed an arbitrary cut to actual capital expenditure on selected projects (Macquarie Park substation for EnergyAustralia and the MetroGrid project) on the grounds that the Commission believes that at least some of the capital expenditure was incurred imprudently. Transend considers that this is not the appropriate approach to take. While it may be difficult to accurately assess the imprudent amount (if any) of a particular project, this assessment is preferable to arbitrary cuts based on a methodology that has not previously been discussed.
- It is possible that the nature of the penalty (disallowing returns during construction) will distort future investment decisions. In particular, large projects with long construction periods will have larger penalties if *any amount* of capital expenditure is considered imprudent. Given that larger projects tend to be more complex and difficult to implement, the expected value of a penalty will be relatively high – thereby tending to discourage TNSPs from undertaking large projects. The Commission appears to have given no consideration to the potentially adverse incentive properties that its approach capital expenditure may introduce.
- For TransGrid, the Commission proposes to introduce an *economic incentive* to minimise the costs of completing the MetroGrid Project. This incentive mechanism will allow TransGrid to recover only 84 cents for every dollar of

future capital expenditure incurred. In Transend's view, it is highly questionable whether this approach is in fact an "economic" as it provides a strong incentive to minimise expenditure, rather than to deliver the project efficiently.

Overall, Transend believes that the Commission's approach to imprudent capital expenditure does not constitute best regulatory practice. The Commission embarked upon an ex post review that it could not complete. Having failed to complete it, the Commission has imposed an arbitrary penalty, the consequences of which could be quite profound.

Transend recognises that the Commission's approach may prove popular with some of the energy customer lobbyists. However, Transend would urge the Commission not to adopt a short-term view on these matters. Instead, the Commission should reconsider whether its proposed approach to addressing apparently imprudent capital expenditure is in the long-term interests of customers. In examining this issue, the Commission should have regard to the adverse impact its decision may have on incentives to invest in large and complex capital expenditure projects.

Capitalisation timing

The Draft Decision for EnergyAustralia states that the Commission will include efficient forecast capital expenditure in the revenue allowance for the 2004-2009 revenue cap decision on an as incurred or cash spend basis. The Commission comments that such an approach is administratively superior and is consistent with the probabilistic capital expenditure forecast utilised in the Commission's most recent revenue cap decisions (Draft Decision, page 52). There does not appear to be any reference to this issue in the TransGrid draft decision. It is also noted that, contrary to the Commission's comments, Transend's final decision actually applied a probabilistic capital expenditure forecast based on commissioning dates, rather than on an "as incurred or cash spend" basis. The Commission should correct this mistake in the Draft Decision.

This Commission's proposed capitalisation approach would need to be considered on a case-by-case basis, as many TNSPs have based their regulatory accounting practices and systems on the DRP, which does not provide for returns on assets, or depreciation of assets until they are commissioned. Such TNSPs also make an allowance for the equity- and debt-financing costs during construction as part of the value of the asset when it is brought into service.

The Commission will need a slightly different version of its post-tax revenue model for a 'spend' approach compared to the present 'in-service' approach.

Unjustified efficiency factor on Operating Expenditure

Transend has previously expressed concern in its own revenue determination at the Commission's approach to operating expenditure. In particular, the Commission imposed a 2% forward-looking "efficiency factor", and provided little justification for doing so. It is worrying that the Commission is now using Transend's revenue cap decision to help justify imposing the same 2% efficiency factor in TransGrid's review. As a matter of principle, the Commission should base its decisions on independent, verifiable findings – rather than relying on its earlier (sometimes poorly justified) decisions as justification for subsequent decisions.

Transend also notes that the Commission has not imposed a 2% efficiency factor in relation to EnergyAustralia. In considering this issue in more detail it is worth distinguishing between:

1. Excluding existing inefficiencies to establish an operating cost allowance for today's "efficient" TNSP; and
2. Anticipating future efficiency improvements, as today's "efficient" company may improve its performance in the next regulatory period.

In Transend's view, incentive regulation requires that the regulator should adjust operating expenditure allowances to reflect item (1), but not item (2). In other words, it is appropriate for the Commission to remove existing inefficiencies from the TNSPs actual operating costs when setting operating expenditure allowances.

It appears that the Draft Decision for EnergyAustralia is properly addressing item (1) – although Transend cannot comment on the appropriateness of the efficiency exclusions recommended by the Commission's consultants. However, the TransGrid draft decision and the Transend final decision applied a 2% efficiency factor in the forthcoming regulatory period. Arguably, this prospective efficiency factor is more akin to item (2), and therefore is inconsistent with good incentive-based regulation (and also inconsistent with the Draft Decision for EnergyAustralia).

It is noteworthy, however, that the Draft Decision for EnergyAustralia (page 71) implies that the Commission believes that the approaches in its recent draft decisions (EnergyAustralia, TransGrid and Transend) are consistent with one another:

The ACCC notes that in other revenue cap decisions (Transend final decision and draft TransGrid revenue cap decision), it has imposed a general efficiency factor to forecast opex allowances. In assessing EnergyAustralia's forecast opex, the ACCC has identified specific cost drivers where scope for efficiency gains can be achieved. Therefore, for this draft decision the ACCC considers that applying a further general efficiency factor to EnergyAustralia's opex is not required.

In summary, Transend doubts whether the ACCC's thinking on this issue is clear. Transend's view is that anticipating future efficiency gains through the imposition of

a 2% efficiency factor is inappropriate. The Commission's reliance on Transend's revenue cap decision to support the on-going application of a 2% efficiency factor is a concern. Transend does not believe that this is consistent with incentive-based regulation, and the need to provide "fair-sharing" of efficiency gains between the company and its customers.

Provision for efficiency glide-path

The Commission's Draft Decision for TransGrid suggests that in the previous revenue cap Decision "no arrangement was made for an efficiency carry-over mechanism". This appears inconsistent with the Draft Regulatory Principles, which made provision for a glide-path for efficiency gains from one period to the next (see page 97). Further, in its Discussion Paper on the review of the Draft Statement of Regulatory Principles (page 39), the Commission claims to have implemented an efficiency carry-over approach:

The Commission's objective is to improve the incentives for TNSPs to reduce costs, but also making sure that the TNSP is adequately compensated for the costs they accrue. As a means of achieving greater incentives the Commission uses an efficiency carry-over. The efficiency carry-over mechanism rewards the TNSP with higher profits when the firm manages to lower its controllable costs.

Transend therefore considers that the present regulatory regime makes provision to glide-path any efficiency gains and that the statement that "no arrangement" exists for TransGrid should be removed.

Weighted average cost of capital

Transend supports the Commission's approach to the cost of capital in a number of important respects. In particular, the Commission has finally accepted that the 10 year bond rate is appropriate for setting the risk free rate. In addition, the Commission's views on the equity beta and the market risk premium reflect a reasonable and balanced judgement of the available evidence.

It is important that the Commission does not take a short-term view in using lower cost of capital estimates to reduce prices. The risks of under-estimating the cost of capital are very substantial indeed. Transend is therefore concerned that the Commission is signalling its future intention to take a narrower view of the WACC, commenting that: "future decisions may place greater weight on contemporary market information in determining appropriate beta values", which in its view indicate that a lower equity beta is appropriate (TransGrid Draft Decision, page 93). Such comments suggest that regulatory risk is an on-going concern.

Non-inclusion of equity raising costs

The Commission's final decision on Transend's revenue cap (page 72) disallowed Transend's claim for equity raising costs on the grounds that:

1. *it is unlikely that Transend would incur equity raising costs during the regulatory period, therefore any provision will have to be notional*
2. *return on equity is a benchmark return calculated by using the CAPM.*

The Commission has used the same words to justify exclusion of these costs in the TransGrid decision, supported further by "consistency" with Transend's Decision (TransGrid Draft Decision, page 84). In Transend's view, the second argument presented by the Commission has no substance or merit. The equity raising costs are distinct from CAPM, which measures the appropriate returns to equity holders, rather than the cost of raising equity funds.

In relation to the first argument, Transend notes that the Commission has consistently provided benchmarked returns irrespective of an entity's actual capital structure. To this end, in Transend's decision the Commission provided debt-raising costs based on benchmarked industry costs and a benchmarked level of debt (60%). However the Commission has been inconsistent in its treatment of equity raising costs. Transend notes that the Commission's discussion paper (page 85) on the Draft Statement of Regulatory Principles, published in August 2003 stated:

As with debt raising costs, the Commission considered it was appropriate to provide a benchmark allowance for equity raising costs in recent decisions. In 2002, the Commission researched equity raising costs and in particular collected the latest information about equity raising costs for several major Australian infrastructure equity raisings. The equity raising costs generally fell between 2.10 and 5.77 % of total equity raised.

On the basis of those data collected by the Commission, a benchmark allowance for equity raising costs (per year) was provided for TNSPs in the operating and expenditure (opex) category.

The Commission concluded its discussion with the following statement (page 86):

The Commission prefers to maintain its approach to providing an allowance for equity raising costs.

Transend was very disappointed that while the Commission implemented this approach in the two most recent revenue cap decisions – and published the same view on this matter in August 2003 – it reached a contrary view by December 2003. It is also frustrating that this change of position was not contemplated in the Commission's Draft Decision for Transend; was not raised until the Decision was released; and therefore the Commission's process precluded Transend from addressing the issue.

In the light of these shortcomings in the Commission's approach, Transend considers that its equity raising costs should be reinstated. Further, Transend considers that the

poor logic used to disallow equity raising costs in Transend's revenue cap decision should not be used as the basis for disallowing these costs in TransGrid's case.

Transparency, consistency and predictability

The Commission has long recognised the importance of developing a transparent, consistent and predictable approach to regulation. The Draft Statement of Regulatory Principles (May 1999, page viii) makes the following observations in this regard:

The Commission believes that:

- *effective communication and consultation should take place between the regulator and all stakeholders, so as to encourage transparent decision making processes*
- *the regulatory process should be predictable, so regulated businesses can feel confident that consistent, well defined decision making criteria will be adopted by the regulator*

In relation to the Draft Decisions, Transend's view is that regulatory practice has fallen short of the goals of transparency, predictability and consistency. In particular:

- The Commission has not provided a detailed explanation of how penalties for imprudent capital expenditure have been calculated. In Transend's experience, calculations which appear "obvious" or "trivial" in theory are often more complex and difficult when applied in different practical examples. Transparency would be improved if a spreadsheet model setting out the calculations were published on the Commission's webpage. This will allow informed comment. Transend would also recommend that these models be included as an appendix in the final decisions.
- Transend would appreciate that any key terms used by the Commission, which may be ambiguous, be defined. For example, the expression "disallow any return on ... investment during the period of ... construction", presumably means the Commission will disallow the benchmark debt and equity financing costs of a project prior to its commissioning, as these are the only returns that accrue to a TNSP *during* the construction phase. These financing costs are rolled-into the asset base as part of the commissioned cost of the asset. It is not clear whether this financing cost is the equivalent of the "returns" the Commission has disallowed.
- The Commission has signalled its intention to consider further capital expenditure submissions from TransGrid and EnergyAustralia *after* the publication of the Draft Decisions. Whilst this is understandable in the sense that the Commission is still developing its "ex ante cap" approach to regulating capital expenditure, it is not in keeping with effective consultation of the building block approach to revenue caps.

- It is not clear how the Commission will address the linkages between forecast capital expenditure (which is yet to be finalised) and operating cost allowances. It appears that the Commission is intending to open-up the issue of future capital expenditure in seeking to implement the ex ante cap approach, whilst leaving the operating expenditure allowances relatively unchanged. This asymmetric approach to setting operating and capital expenditure could lead to inappropriate outcomes. It is also not clear whether the Commission intends to revisit or “lock in” other aspects of the Draft Decision (for example the WACC parameters, which may be affected by risk changes resulting from a new ex-ante capex regime) in the short term, or whether these may be revised at the time of the next Draft Decision.
- The Commission’s approach to penalising imprudent capital expenditure (by disallowing “returns during construction”) has not been anticipated in the Commission’s Statement of Regulatory Principles or in any subsequent paper published by the Commission. Therefore the Commission’s Draft Decisions strongly suggest that the regulatory framework remains somewhat unpredictable – even 5 years after the publication of the Draft Statement of Regulatory Principles.
- For TransGrid, the Commission notes that it has adopted TransGrid’s model for roll-forward of the asset base to calculate the RAB at the end of the current regulatory period. The Commission goes on to say (page 9),

However, the ACCC is still considering whether an approach that relates the closing RAB to the opening RAB and the present value of actual opex, capex, tax and revenue (“the cash flow approach”) would be more advantageous.

This alternative “cash flow approach” does not appear in any of the public documentation outlining Commission’s thinking on regulatory principles. It has not been explained in the TransGrid Draft Decision, nor has the basis for evaluating the advantages of any roll-forward approach. Yet this alternative approach is still under consideration!

To some extent, the weaknesses of the Draft Decisions in terms of transparency, consistency and predictability reflect the on-going changes in the Commission’s approach to regulation as it gains more experience with revenue cap reviews. In particular, the Commission has been reconsidering its approach to regulating capital expenditure to provide better-balanced incentives for TNSPs and to simplify the task of conducting ex post prudency reviews.

Transend welcomes and supports the Commission in its initiatives to develop better approaches to regulation. However, it is disappointing that many aspects of the regulatory regime still appear unsettled – even after the completion of numerous revenue cap decisions. Importantly, the Commission should give careful consideration as to how it will ensure consistent approaches to regulation over time (and thereby enhance predictability) as the regulatory framework moves towards

finalisation. The Commission should also ensure in future that the “ground rules” for regulatory resets are established well in advance of commencing the review.

Transend notes that TransGrid, EnergyAustralia and Transend will all be subject to revenue cap reviews in 2009. Given the approach to capital expenditure signalled in the Draft Decisions, it is unlikely that all three companies will be regulated in a consistent manner. As a matter of principle, such an outcome (10 years after the framework was first defined) seems inappropriate. However, given that the revenue caps have been set under different regimes, it will be important to understand and distinguish between the review processes applicable to each TNSP.

Transend would like to work with the Commission in the coming months to ensure that regulation is transparent, consistent and predictable. This requires careful thought about how the lessons from the Draft Decisions for EnergyAustralia and TransGrid should be applied to existing and future revenue cap determinations.

Future regulatory developments

As noted above, the Draft Decisions reflect the relatively confused and incomplete state of the regulatory framework with to revenue determination. In Transend’s view, it is important that the Commission consolidates its thinking with regard to revenue regulation so that it delivers transparent, consistent and predictable outcomes. Transend is happy to work with the Commission to resolve outstanding issues in the coming months.

In the meantime, Transend urges the Commission to rely more on the incentive properties of well-designed regulation to deliver appropriate outcomes to customers. At present, the Commission appears to be moving towards more intrusive forms of regulation, focused on second-guessing investment decisions and re-examining the efficiency of actual operating expenditure. The history of regulation – particularly in the US – is that regulators are generally poorly equipped to step into the companies’ shoes to determine the most appropriate course of action (either ex post or ex ante).

It will deliver enormous benefits to all if the Commission can create appropriate incentives for companies to deliver efficiency gains, and to spend capital expenditure prudently. Transend would welcome a continuing dialogue with the Commission on these matters.