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30 January, 2004

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Dear Sebastian

VENCORP'S COMMENTS ON TRANSGRID'S REVENUE CAP APPLICATION

Thank you for the opportunity to comment on the Transgrid's revenue cap application for the period 2004 to 2009. Please find attached our comments for your consideration.

If you wish to discuss any aspect of this submission, please telephone Mr Joe Spurio on (03) 8664 6613.

Yours faithfully

A handwritten signature in black ink, appearing to read 'M. Zema', written in a cursive style.

Matt Zema
Chief Executive Officer



COMMENTS ON

**TRANSGRID'S REVENUE CAP APPLICATION
FOR THE PERIOD 1 JULY 2004 TO 30 JUNE 2009**

30 January 2004

VENCorp's comments on TransGrid's revenue cap application for the period 1 July 2004 to 30 June 2009

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1 Executive Summary

In November 2003, the Commission invited interested parties to comment on issues relating to the determination of an appropriate revenue cap for TransGrid, the owner and operator of the New South Wales electricity transmission system. The key points of VENCORP's submission are summarised below.

Performance incentives and service obligations TransGrid's application proposes the implementation of a performance incentive scheme that is consistent with the requirements of the Commission's *Service Standard Guidelines*. VENCORP considers that there is scope to improve the performance incentive arrangements mandated by the *Guidelines*, without necessarily having to resolve the difficult issues identified by TransGrid in its application. The performance incentive scheme that presently applies to SPI PowerNet is an example of arrangements that provide stronger incentives to the network asset owner to optimise the availability of network infrastructure, having regard to:

- the potential market impacts of the infrastructure being unavailable; and
- the need to ensure that the transmission asset owner is not unduly exposed to risks that are beyond its control.

VENCORP suggests there is merit in the Commission considering the applicability of a similar scheme to TransGrid.

VENCORP also considers there would be merit in the Commission considering including in each TNSP's revenue cap determination a more comprehensive definition of service standards and obligations, so that the TNSP is required to contribute appropriately and efficiently to the maintenance of a defined level of inter-regional transfer capability.

Planning and Investment Criteria TransGrid's network investment criteria appear to be based on an interpretation of Schedule 5.1 of the Code that differs somewhat from VENCORP's interpretation. These different interpretations have the potential to lead to the application of different investment criteria. This, in turn may lead to different levels of transmission investment (and possibly network reliability) in different regions of the NEM. Such factors may, at least partially, explain the relatively high level of transmission capital investment undertaken recently, and planned for, in New South Wales, compared to Victoria.

Capital expenditure VENCORP agrees in principle with TransGrid's proposal that the TNSP should be permitted to roll-in to the regulated asset base the efficient costs of all investments that satisfy the Regulatory Test.

VENCORP suggests that arrangements relating to the full recovery of capital expenditure in excess of that provided for in the revenue cap should distinguish between:

- capital expenditure within the control of the network owner (such as asset renewals); and
- capital expenditure driven by factors beyond the control of the network owner (such as demand and generation-development related expenditure).

Accordingly, it is suggested that:

- A fixed benchmark amount for capital expenditure (possibly relating to a defined package of works) that is within the reasonable control of the network asset owner should be provided, and that asset owner should bear the risk associated with variations between actual and benchmark expenditure.
 - For growth and generation-related expenditure (which is not within the reasonable control of the TNSP) regulatory arrangements should enable the full recovery of the efficient costs associated with delivery of services, subject to the requirements of the Regulatory Test.
-

Operating expenditure

There appears to be a need for the Commission to examine the causes of the apparent increase in TransGrid's actual operating expenditure towards the end of the present regulatory period, and to consider the extent to which recent actual operating expenditure might provide a reasonable basis for developing forecasts of future efficient operating expenditure.

It would also be helpful for the Commission to present a comparison of TransGrid's actual and forecast operating costs with those of other Australian TNSPs (including the combined operating costs of VENCORP and SPI PowerNet).

Cost of Capital

TransGrid's application notes the Productivity Commission's view that the public benefit is unlikely to be served if unduly harsh regulatory decisions diminish incentives for efficient new infrastructure investment. VENCORP concurs with such views. However, VENCORP also considers there is a need for regulatory decisions to ensure that the prices paid by users of monopoly services are fair and reasonable, having regard to the risks borne by service providers, and the efficient cost of service provision including a normal return on capital.

TransGrid's application suggests that the provision for the cost of capital should include an additional margin (above the market cost of capital) to provide additional incentives to TransGrid to 'champion' an efficient level of projects, and to cover costs associated with approval processes. VENCORP questions the rationale for any such margin, given that:

- provisions for all of the costs referred to by TransGrid should already be included in a TNSP's regulated revenue stream;
- the market cost of capital represents the return that investors expect to receive on a risky investment, and it also represents the price at which that risk is freely traded in the capital market; and
- there appears to be limited scope for such a margin to be accommodated within the relevant provisions of the Code.

Asset valuation

VENCORP strongly concurs with the Commission's preferred position (as stated in its Discussion Paper on the draft SoRP), and the conclusions of the Commission's independent advisers (the Allen Consulting Group) that:

- Revaluation of the regulatory asset base using Optimised Depreciated Replacement Cost principles is not feasible in the short-term, nor does it provide appropriate investment incentives for regulated transmission providers over the long term.
- The preferred approach is for the regulatory asset value at the end of a regulatory period to reflect the asset base value at the commencement of that period, plus the capital expenditure undertaken (assuming efficient execution of projects that meet the Regulatory Test), less depreciation on the regulatory asset base, – that is, the "rolling forward" methodology.

Incentive arrangements

VENCORP concurs with TransGrid's suggestion that there is a need for the incentive mechanisms of the revenue cap to be clearly specified as part of the determination.

VENCORP agrees with TransGrid's proposition, that TransGrid's revenue cap for the forthcoming regulatory period should not include the carried-forward value of any efficiency gains made (or losses incurred) in the first period.

The Code requires the application of "incentive based" regulatory arrangements. The incentive properties of the provisions relating to the remuneration and recovery of capital expenditure proposed by TransGrid should be carefully examined by the Commission in light of the relevant Code provisions.

2 Introduction and background

2.1 Purpose of this paper

In November 2003, the Commission invited interested parties to comment on issues relating to the determination of an appropriate revenue cap for TransGrid, the owner and operator of the New South Wales electricity transmission system. This submission sets out VENCORP's comments.

2.2 Rationale for, and scope of VENCORP's submission

TransGrid's revenue cap application¹ properly recognises that VENCORP is one of TransGrid's key stakeholders. VENCORP has an interest in the outcome of the Commission's review of TransGrid's revenue cap, in the following areas:

- The performance of TransGrid's network directly affects the transfer capability between NSW (Snowy) and Victoria. VENCORP therefore has an interest in seeing that TransGrid has incentives to optimise the performance of its assets insofar as this affects inter-regional transfer capability and the delivery of network services to Victorian network users.
- As noted throughout TransGrid's application, this review represents the first time that the Commission will have conducted a second revenue cap determination for a TNSP. The Commission's decisions in this revenue cap determination therefore have the potential to set "precedents" for future decisions. VENCORP has a legitimate interest in commenting on matters of precedent or principle that may influence future revenue cap decisions applying to VENCORP (as the monopoly provider of transmission services in Victoria) or SPI PowerNet (as the principle owner of Victorian transmission assets).
- VENCORP is interested in contributing to the on-going discussion of network planning and investment criteria, especially in light of the Ministerial Council on Energy's *Report to COAG* of 11 December 2003.²
- To the extent that Victorian users may in the future make a net contribution to TransGrid's revenue (through some form of inter-jurisdictional TUoS charges, for instance), then VENCORP has an interest in seeing that TransGrid's revenue represents fair value for money, having regard to the risks borne by TransGrid in the provision of services.

¹ Refer to page 10 of TransGrid's application.

² On page 10 of its report, the MCE adopts a number of principles to underpin transmission policy in the NEM. These principles include the following: "Transmission investment decisions should be timely, transparent, predictable and nationally consistent, at the lowest sustainable cost."

3 Performance incentives and service obligations

Page 11 of the MCE's *Report to COAG* states:

"Transmission companies are currently subject to service availability and capacity requirements. However, the MCE considers that there would be valuable customer and investor benefits in more closely aligning transmission performance measures with their market impact. The MCE supports the current consideration by the ACCC of incentives for availability. Incentive arrangements should analyse the actual cost of constraints, set targets for circuit availability, and reward or penalise transmission companies for diversion from those target levels. These arrangements should be implemented in 2004."

TransGrid's application proposes the implementation of a performance incentive scheme that is consistent with the requirements of the Commission's *Service Standard Guidelines*. In addressing expectations that TNSPs should be more responsive to market conditions, page 88 of TransGrid's application states:

"TransGrid recognises that a number of stakeholders remain concerned about the potential impact of transmission outages on wholesale trading positions and that there is a perception that these risks are a significant factor inhibiting interregional hedging. A process is required to address these concerns in a way that improves the value delivered by transmission networks to the community. This process could involve a working group, convened by the Commission, to develop proposals for wider consideration."

VENCorp concurs with TransGrid in relation to this matter. VENCorp also agrees with TransGrid's suggestion (on page 88 of its application) that there remains a need to fully explore the issue of whether market efficiency would be enhanced under arrangements where TNSPs provided certainty of outage timing, versus arrangements under which TNSPs are incentivised to change the timing of outages in response to pool price signals.

Notwithstanding this, VENCorp considers that there is scope to improve the performance incentive arrangements mandated by the Commission's *Service Standard Guidelines*, without having to resolve the difficult issues identified by TransGrid on pages 88 to 90 of its application.

For instance, the performance incentive scheme that presently applies to SPI PowerNet provides stronger incentives to the network asset owner to optimise the availability of network infrastructure, having regard to the potential market impacts of the infrastructure being unavailable. At the same time:

- the scheme does not unduly expose the transmission asset owner to risks that are beyond its control; and
- the total financial exposure of the transmission asset owner under the scheme is also capped at 2% of SPI PowerNet's regulated revenue.³

This scheme goes some considerable way to providing tangible commercial incentives to the network asset owner to manage assets in a way than maximises the value of network services to market participants. Given the material (yet manageable) financial exposure faced by the network asset owner, the scheme also goes some considerable way to addressing the concerns of participants regarding the incentives on the network owner to manage transmission outages and asset performance having regard to the associated market impacts.

The attachment provides an overview of the scheme. VENCorp would be pleased to provide further details to the Commission in the course of the review.

A further point on which VENCorp wishes to comment relates to the definition of TransGrid's service obligations. VENCorp considers that the issue of service obligations - particularly where this relates to the rated capacity of transmission assets - is worthy of careful examination by the Commission. The issue is perhaps best illustrated by way of the following example.

³ This level of exposure is somewhat higher than the 1% of total revenues suggested in the Commission's *Service Standard Guidelines*.

In August 2003, NEMMCO Communication No.1252 advised of changes to ratings used by NEMMCO for Internal Snowy Transmission lines. VENCORP understands that these changes had the effect of de-rating certain Snowy transmission assets, resulting in a reduction in the transfer limit from Snowy to Victoria under certain system conditions. It is also understood that the changes to Snowy transmission asset ratings were initiated by TransGrid following Transgrid's acquisition of the assets. Under the present arrangements:

- Victorian network users had no effective means of participating in the decision to de-rate assets which affect transfer limits into Victoria;
- there was no independent verification of the need for, and magnitude of de-rating; and
- there is no clear mechanism available to compensate Victorian network users for the additional costs they might incur as a result of the de-rating.

VENCORP suggests that there is merit in the Commission considering including in each TNSP's revenue cap determination a more comprehensive definition of service standards and obligations, so that the TNSP is required to contribute appropriately and efficiently to the maintenance of a defined level of inter-regional transfer capability. VENCORP would be pleased to discuss this issue in greater detail with the Commission at any time.

4 Planning and Investment Criteria

In its *Report to COAG*, the Ministerial Council on Energy adopted a number of principles to underpin transmission policy in the NEM. These principles include the following:

"Transmission investment decisions should be timely, transparent, predictable and nationally consistent, at the lowest sustainable cost."

TransGrid's submission correctly notes that the National Electricity Code contains provisions relating to planning and network reliability with which all TNSPs are required to comply. These provisions form a framework for nationally consistent transmission investment decisions. However, TransGrid's network investment criteria appear to be based on an interpretation of Schedule 5.1 of the Code that differs somewhat from VENCORP's interpretation.⁴ These different interpretations have the potential to lead to the application of different investment criteria. This, in turn may lead to different levels of transmission investment (and possibly network reliability) in different regions of the NEM. Such factors may, at least partially, explain the relatively high level of transmission capital investment undertaken recently, and planned for, in New South Wales, compared to Victoria.

5 Capital Expenditure

5.1 Treatment of additional capital expenditure undertaken in the first regulatory period

In its submission to the Commission's consultation on the *Statement of Regulatory Principles*, VENCORP suggested that once the Commission has confirmed that the requirements of the Regulatory Test have been met, there should be no further risk of re-optimisation or asset revaluation borne by the TNSP. VENCORP also noted that this would be consistent with the Commission's preferred position of rolling in new investment at cost.

⁴ The different interpretations adopted by the two organisations are illustrated by comparing section 3.2.1 of TransGrid's application (pages 22 and 23) with VENCORP's Electricity Transmission Network Planning Criteria, a copy of which is available from VENCORP's website at: http://www.vencorp.com.au/docs/Electricity_Transmission/Transmission_Planning/Elec%20Trans%20Plan%20Criteria%20June2003.pdf

Accordingly, VENCORP agrees in principle with TransGrid's proposal that the TNSP should be permitted to roll-in to the regulated asset base the efficient costs of all investments that satisfy the Regulatory Test.

TransGrid's application notes that the company's actual capital expenditure during the first regulatory period exceeded the revenue cap benchmark amount by around \$180 million in aggregate. TransGrid is seeking the inclusion of the (written down) value of this additional investment in the regulated asset base at the commencement of the second regulatory period. In addition, TransGrid is also seeking full compensation for the (as yet unrecovered) costs associated with the return on, and return of that additional capital in the first regulatory period. To the extent that the additional investment satisfies the Regulatory Test **and** represents the efficient cost of executing the projects **and** is the result of factors beyond TransGrid's control, then it would seem reasonable for TransGrid to be permitted to recover the full costs of such investment.

In this regard, and in the context of the incentive-based regulatory regime mandated by the Code, it seems appropriate to distinguish between:

1. additional capital expenditure associated with unforeseen growth and generation development (a matter largely beyond the control of the TNSP); and
2. additional capital expenditure associated with renewal of existing assets (a risk that an asset owner is best placed to manage, and a risk for which the asset owner should be compensated under the revenue cap).

The allocation of growth forecast risk to a TNSP operating under a fixed revenue cap serves no economic purpose. Indeed, it can be argued that the allocation of such risk to the TNSP under a fixed revenue cap regime may create commercial disincentives for the TNSP to provide services to unanticipated new customers.⁵ In principle therefore, there appear to be good reasons to allow TNSPs to fully recover the efficient costs associated with unforeseen demand growth and generation development.

However, in the case of the second category of capital expenditure (ie, that relating to the renewal, refurbishment and replacement of existing assets) there are good reasons to not automatically allow **full** pass-through of unforeseen cost increases. This is because the TNSP (as asset owner) is best placed to manage the risks associated with asset maintenance, performance and availability over the life cycle. Allowing the asset owner to fully pass through the cost of unforeseen increases in asset management-related capital expenditure would diminish the incentives on the asset owner to manage and maintain the assets in a way that minimises total life cycle costs. This, in turn would lead to the effective transfer of asset management and asset performance risk (the core business activity of the asset owner) to network users, and the likelihood of an inefficient increase in total life cycle costs. Therefore, there appear to be sound reasons to not allow the immediate and automatic pass-through of such cost increases. Commercial network asset owners should absorb (or benefit from) any cost increases (or decreases) within the regulatory period, and then the written-down value of the actual expenditure (which might reasonably be inferred to be efficient) should be rolled into the regulated revenue base at the next review.

5.2 Capital expenditure forecasts

The considerations discussed in Section 5.1 above have implications for the way in which benchmark expenditure allowances are provided in the revenue cap. Given these considerations, it is suggested that:

- A fixed benchmark amount for capital expenditure (possibly relating to a defined package of works) that is within the reasonable control of the commercial network asset owner should be provided, and that

⁵ This is because if the costs of providing services to these "unanticipated" new customers have not been provided for in the revenue cap, then the network owner will incur a reduction in shareholder value, to the extent that the revenue stream is not adjusted to reflect the increase in costs and the network owner is required to absorb these unanticipated cost increases.

asset owner should bear the risk associated with variations between actual and benchmark expenditure until the next regulatory review.⁶

- For growth-related expenditure (which is not within the reasonable control of the TNSP) regulatory arrangements should enable the full recovery of the efficient costs associated with delivery of services, subject to the requirements of the Regulatory Test.

The data in Figure 5.8 (page 63) of TransGrid's application indicate the high level of uncertainty associated with forecasting aggregate (that is, growth-related and renewals) capital expenditure. (In addition, it is noteworthy that around 80%, or \$1.1 billion of TransGrid's forecast of aggregate capital expenditure for the regulatory period is dependent on relatively uncertain demand and generation development.)⁷ To address this uncertainty, TransGrid proposes arrangements based on the approach adopted by the Commission in other recent electricity revenue cap decisions. Under this approach, a probability-weighted capital expenditure forecast is derived from a number of different scenarios. This "expected value" forecast is incorporated into the revenue modelling used to set the revenue cap, but ex-post adjustments are made to the revenue cap to correct for differences between forecast and actual capital expenditure. For the reasons set out in Section 5.1 above, VENCorp questions the effectiveness and incentive properties of this model.

In its response to the Commission's draft electricity transmission revenue cap decision for Tasmania, Transend Networks proposed an arrangement that would distinguish between the capital expenditure within the control of the network asset owner, and the (uncertain) capital expenditure related to customer number and demand growth. The approach proposed by Transend is aimed at:

- maximising the incentives on the asset owner to undertake controllable capital expenditure efficiently;
- ensuring that the TNSP is not unduly exposed to demand forecast risk; and
- obviating the need to develop a revenue cap based on a forecast of "average capital expenditure" derived from a suite of mutually exclusive scenarios, and then adjusting the revenue cap after the event to correct for any differences between the forecast and actual expenditure

VENCorp suggests that arrangements along the lines of those proposed by Transend in its submission to the Commission have merit (in the context of regulatory arrangements applying to commercial asset-owning TNSPs) and are worthy of the Commission's careful consideration. In addition, Section 6.3 of VENCorp's submission to the Commission's consultation on the *Statement of Regulatory Principles* set out some comments on capex forecasting and treatment of under-spending or over-spending on the allowed capex. The Commission may wish to consider those comments in the context of the present revenue cap determination.

6 Operating expenditure

In its submission to the Commission's consultation on the *Statement of Regulatory Principles*, VENCorp noted that the approaches applied to date by the Commission in its electricity transmission revenue cap determinations could reasonably be argued to provide regulated entities with an incentive to make their costs appear higher towards the end of the regulatory period.

With this consideration in mind, it is noted that TransGrid's actual operating expenditure remained flat (in real terms) in the first three years of the first regulatory period, at a level consistent with the benchmark provision contained in its revenue cap. However, in the final two years of the regulatory period (2002/03 and 2003/04) TransGrid's operating expenditure increased in nominal terms by 10% and 6%, respectively. The operating expenditure benchmark proposed by TransGrid for the first year of the second regulatory period (2004/05) is 7% higher in nominal terms than the expected actual expenditure for 2003/04.

⁶ Sections 6.2 and 6.3 of VENCorp's submission on the Commission's *Statement of Regulatory Principles* contained some discussion of matters relating to the remuneration of capital expenditure relating to renewal and replacement of existing assets.

⁷ Refer to Table 5.4, on page 71 of TransGrid's application.

TransGrid's application presents explanations to account for these variations. It would be helpful for the Commission to examine the possible causes of these variations in further detail, and to present a comparison of TransGrid's actual and forecast operating costs with those of other Australian TNSPs (including the combined operating costs of VENCORP and SPI PowerNet).

TransGrid's application also proposes the adjustment of the Commission's "ex ante" operating cost benchmarks for the first regulatory period to account for variations between actual and forecast conditions in that period. The adjusted benchmarks are then used to substantiate TransGrid's forecasts of efficient operating costs for the second regulatory period. One of the adjustments proposed is to increase the benchmarks to account for "increased network size resulting from around \$1,000 million of new assets being installed over the current regulatory period and which now require monitoring and maintenance"⁸. Application of such an adjustment implies that the Commission's 1999 operating cost benchmarks did not allow for the forecast growth in TransGrid's asset base over the regulatory period.⁹ It would be helpful if the Commission were to examine and clarify this matter. It would also be helpful for the Commission to examine the basis of the adjustments proposed by TransGrid, and if possible, to include an analysis of:

- the way in which such matters have been treated by TNSPs and the Commission in its other revenue cap decisions; and
- the relevance of past actual expenditure and adjusted benchmarks in determining forecasts of future efficient costs.

7 Cost of Capital

TransGrid's application notes the Productivity Commission's view that the public benefit is unlikely to be served if unduly harsh regulatory decisions diminish incentives for efficient new infrastructure investment. VENCORP concurs with such views. On the other hand however, VENCORP considers there is a need for regulatory decisions to ensure that the prices paid by users of monopoly services are fair and reasonable, having regard to the risks borne by service providers, and the efficient cost of service provision including a normal return on capital.¹⁰

VENCORP recognises that there is a degree of tension between the commercial interests of users and providers of monopoly services, however all stakeholders share a common interest in ensuring that incentives for efficient on-going investment in, and operation and maintenance of network assets exist. Together, these considerations suggest the need for a regulatory decision that appropriately balances the commercial interests of different stakeholders, and which provides a robust foundation for the efficient on-going provision of reliable services by TNSPs.

TransGrid's application sets out a suggestion that the provision for the cost of capital should include an additional margin (above the market cost of capital) to "help ensure that TransGrid has adequate incentive to 'champion' an efficient level of projects over regulatory approval hurdles, negotiate demanding public consultation processes, manage environmental approval processes, defend any legal challenges and take on the ownership risks associated with those assets".¹¹

⁸ Refer to page 78 of TransGrid's application.

⁹ It is noted that the Commission's revenue cap decision included an aggregate allowance of nearly \$900 million for capital expenditure during the whole of the first regulatory period.

¹⁰ It is noted that clause 6.2.3(d)(5) of the Code refers to the need for regulatory decisions to have regard to the need to balance the interests of regulated companies and their customers. Clause 6.2.2(c) requires the Commission to administer a regulatory regime that seeks to achieve a number of outcomes, including "prevention of monopoly rent extraction by Transmission Network Owners and/or Transmission Network Service Providers (as appropriate)".

¹¹ Refer to page 108 of TransGrid's application. It is noted that page 126 of the application states:

"For the avoidance of doubt, TransGrid **has not** included such a margin in its calculation of the WACC values, but requests the Commission to give explicit consideration to this proposal, both in relation to this Application and the settling of the regulatory principles to apply to transmission revenue regulation generally."

VENCorp questions the rationale for any such margin, given that:

- provisions for all of the costs referred to by TransGrid are already included in a TNSP's regulated revenue stream; and
- the market cost of capital represents the return that investors expect to receive on a risky investment, and it also represents the price at which that risk is freely traded in the capital market.

It would be helpful for the Commission to consider whether the suggestion made by TransGrid could be accommodated within the requirements of clauses 6.2.2(b)(2), 6.2.2(c), 6.2.2(d), 6.2.3(d)(4), 6.2.4(c)(4), and Schedule 6.1 of the Code.

8 Asset valuation

VENCorp commented extensively on issues relating to asset valuation in its submission to the Commission's consultation on the *Statement of Regulatory Principles*. As noted in that submission, VENCorp strongly concurs with the Commission's preferred position, and the conclusions of the Commission's independent advisers (the Allen Consulting Group) that:

- Revaluation of the regulatory asset base using Optimised Depreciated Replacement Cost principles is not feasible in the short-term, nor does it provide appropriate investment incentives for regulated transmission providers over the long term.
- The preferred approach is for the regulatory asset value at the end of a regulatory period to reflect the asset base value at the commencement of that period, plus the capital expenditure undertaken (assuming efficient execution of projects that meet the Regulatory Test), less depreciation on the regulatory asset base, – that is, the “rolling forward” methodology.

It would be helpful for the Commission to carefully assess TransGrid's application of the rolling forward methodology.

9 Incentive arrangements

VENCorp's submission to the Commission's consultation on the *Statement of Regulatory Principles* commented on the issue of incentive arrangements.¹² VENCorp invites the Commission to consider those comments in the context of the present revenue cap determination.

TransGrid's application sets out a number of principles relating to the operation of incentive arrangements, however the application does not specify the mechanisms that would give effect to these principles. TransGrid's application correctly notes the importance of providing regulatory certainty – and the positive impact that such certainty has on investment incentives. A key area in which commercial TNSPs require certainty relates to the treatment in future regulatory periods of efficiency gains made in the present period. It is noted that TransGrid has sought further consultation with the Commission in relation to this matter.

It is also noted that page 84 of TransGrid's application states:

“TransGrid is not seeking a retrospective efficiency carryover to be applied in transitioning from the current regulatory period due to the lack of any transparent framework being enunciated during the current regulatory period.”

VENCorp concurs with TransGrid's position in relation to the carrying forward into the second regulatory period any efficiency gains (or losses) incurred in the first period.

¹² Refer to Sections 6.2, 7.1 and 8 of VENCorp's submission.

Finally, VENCORP notes that clauses 6.2.2(b) and 6.2.3(d)(1) require the application of "incentive based" regulatory arrangements, while clause 6.2.4(a) states that: "Economic regulation is to be of the CPI minus X form, or some incentive-based variant of the CPI minus X form". It is understood that these provisions were included in the Code to ensure that the negative outcomes associated with traditional "rate of return" regulation would be avoided. The provisions relating to the remuneration and recovery of capital expenditure proposed by TransGrid might possibly be construed as being a form of "rate of return" regulation. Given the uncertainties associated with (large and infrequent) capital investment in transmission, and the characteristics and incentive properties of fixed revenue caps, such arrangements may be unavoidable. Moreover, as noted by TransGrid, it is essential that reasonable certainty of cost recovery be provided to ensure that adequate incentives are maintained to encourage an efficient level of on-going investment.¹³ However, as noted in Section 5 of this submission, alternative arrangements have been proposed and are worthy of consideration. It would be helpful if the Commission could carefully examine and consult on these issues in further detail over the course of this review.

¹³ Indeed, clause 6.2.3(d)(5) requires the Commission to provide reasonable certainty and consistency over time of the outcomes of regulatory processes having regard for (amongst other things):

- the need to balance the interests of users and TNSPs;
- the capital intensive nature of the transmission sector, the relatively long lives of transmission assets, and the large and relatively infrequent augmentation of the transmission network; and
- the need to minimise the economic cost of regulatory actions and uncertainty.

Attachment: Overview of SPI PowerNet performance incentive scheme

1. Purpose and Objectives of Availability Incentive Arrangements

This Availability Incentive Scheme (AIS) is a simplified alternative to a fully market based approach to driving network owner performance. The AIS provides economic signals which:

- encourage SPI PowerNet (as network owner) to seek plant outages at times when the expected cost¹⁴ to wholesale electricity market participants of an outage is minimal;
- encourage asset management practices which assist in ensuring that the actual cost¹ borne by market participants due to unavailability of transmission assets is minimised;
- in conjunction with benchmark / target performance standards for network availability, encourage asset management¹⁵ practices which assist in delivering performance expectations over the long run; and
- is consistent with the principle that network owners should be exposed to risks which are most effectively and efficiently managed by themselves.

2. Operation of the Scheme

The AIS operates by applying an hourly rebate to all transmission element outages from any cause, except defined Force Majeure events and other excluded causes. At times of low system demand, the availability rate (i.e. the cost to SPI PowerNet of assets being unavailable) would be very low, encouraging maintenance during these periods. The high level of rebates during peak periods discourage maintenance during these periods, and encourages more efficient work practices, such as live line maintenance.

The AIS has rebates for each transmission element set for 3 periods:

- Peak (Mid November to Mid March daytime weekdays)
- Intermediate (June to August daytime weekdays)
- Off Peak – All other times

Rebates are set for each transmission element based on the criticality of that element to the network, taking into account the increase in potential unserved energy, cost of electrical losses resulting from the outage, and the cost of rescheduling generation.

¹⁴ This cost includes the sum of costs associated with generation re-scheduling due to transmission constraints, marginal transmission losses and involuntary load shedding.

¹⁵ Asset management encompasses asset replacement, refurbishment, replacement, maintenance and any other activity employed by network owners to maintain the operating capability of its assets.