

ENERGY USERS ASSOCIATION OF AUSTRALIA

and

ENERGY ACTION GROUP

TRANSEND REVENUE APPLICATION

SUBMISSION TO ACCC

and

REPORT TO NEM ADVOCACY PANEL

This document was commissioned by the NEM Advocacy Panel. Assistance in preparing the document was provided by McLennan Magasanik Associates, with input from Bardak Group and Pareto Associates. However, the views expressed herein are those of the EUAA and EAG.

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EXECUTIVE SUMMARY

Transend's application does not demonstrate adequate justification for the requested revenue increase to meet its network service obligations. We believe that Transend's application grossly inflates their revenue requirements, which will result in the imposition of unreasonable transmission use of system charges on customers. Specifically, the main issues of concern to us are:

- The Regulatory Asset Base has been unreasonably revalued from the level accepted by its current regulator, OTTER.
- Capex has been underspent in the current regulatory period, yet Transend attempts to seek even greater allowance for capex in the next regulatory period.
- On most benchmark measures of capex, Transend's application is seen to be significantly higher than other comparable TNSPs. It is only when Basslink's export capacity is included that the capex applied starts to look comparable.
- The WACC applied is at least 50 to 100 basis points above a reasonable level compared with interstate and international benchmarks.
- Opex increases by almost 100% over the current regulatory period and may indicate that Transend has become less efficient or is exercising "strategic behaviour".

EUAA and EUG also submit that:

- The process of completing revenue reviews and re-sets for all regulated TNSPs at the same time, would best provide for consistent regulatory approaches to TNSPs across the NEM. Transend's attempts to avoid scrutiny on a number of performance indicators on spurious grounds would then be more clearly evident.
- A 1% revenue at risk, as proposed as a service incentive, is surely insufficient incentive for such an organisation. Based on its pre-revaluation equity of \$395M, Transend is seeking to achieve a return on equity of over 15% in 2004. A 1% reduction in revenue does not make a significant impact on such a high level of return on equity.
- A monopoly service provider's attempt to triple its profit before tax over 7 years must be seen as unreasonable and an attempt to exploit its monopoly power.
- Transend's performance standards in servicing its 'customers' are of utmost importance to end use customers, who are required to pay virtually all TuoS in the NEM, and as such meaningful incentives to maintain and improve performance are required.

The ACCC's review of Transend's revenue application should also consider the impact of Tasmania's entry into the NEM and developments in the energy market. Specifically, we would like the ACCC review to take into account the extent to which:

- Basslink operation requires additional investment to manage the increased power flows in the Tasmanian transmission system.
- The development of wind power will similarly impose additional capital costs.
- Future operating costs incurred by Transend will ultimately be transferred to NEMMCO when the NEM commences in Tasmania

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- The plans of Transend have made provision for the support of some distributed generation that could defer capital expenditure in the network, but the impact of this is not evident in the Application.

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1 INTRODUCTION

The Energy Users Association of Australia (EUAA) and the Energy Action Group (EAG) appreciate the opportunity to provide comments for consideration on Transend's Revenue Cap Application to the Australian Competition and Consumer Commission (ACCC) and in doing so to furnish a report on the Application to the NEM Advocacy Panel.¹ This submission addresses the main issues of concern to our members (large and small energy users) and seeks to ensure that these issues are captured in the ACCC's consultation process. It is our view that Transend's application clearly demonstrates that the revenue increase requested by Transend to meet its network service obligations has not been adequately demonstrated.

The major issues of concern discussed in this response are:

- The substantial increase in the Regulatory Asset Base (RAB).
- Forecast Capital Expenditure (capex) in the current application has significantly increased compared with Transend's previous forecasts, without adequate justification.
- Incentives for Transend to accurately forecast capex.
- The Weighted Average Cost of Capital (WACC) requested by Transend is higher than the two most recent revenue decisions in other states and internationally, by at least 50 to 100 basis points.
- The increase in Operation and Maintenance (O&M) expenditure by 100% over the two regulatory periods.
- The importance of Transend's performance standards in servicing end users.

2 REGULATORY ASSET BASE

The Regulatory Asset Base (RAB) has been substantially revised upwards in 2001 from the asset base accepted by the Office of the Tasmanian Electricity Regulator (OTTER) in 1999, which was submitted for the previous revenue determination. In its Application, Transend does not provide any justification for this substantial upward revision from its previous value but only states that *"SKM's valuation approach is consistent with the New South Wales Treasury document Policy Guidelines for Valuation of Network Assets of Electricity Network Businesses first issued in December 1995"*.

In Section 5.3.4.3, Table 5.6 of OTTER's 1999 final report², the asset values started with an asset base of \$333.25m on 1 July 1998, with forecast asset values rising to \$468.71M by 30

¹ The EUAA/EAG were commissioned by the NRM Advocacy Panel to provide a report on the Transend Application and accordingly this paper is being provided to both the ACCC and the Panel.

² Investigation into Electricity Supply Industry Pricing Policy, Pricing Determination, OTTER, December 2000

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June 2002, an increase of 40% over its 1998/99 asset base. The final asset values in 1999 included a forecast capex up to June 2002 totalling \$202.7M.

Table 4 of Transend's 2002 Annual Report, states that actual capex between 1999 and 2002 amounted to just \$151.4M, a reduction from the forecast of over \$51M. However, the asset base in Transend's current 2002/03 Application had been increased to \$542.2M, an increase of almost 63% over its 1998/99 asset base, before taking into account inflation and depreciation.

How is it possible that the value of the asset base could have increased by a greater amount over the current regulatory period when the capex incurred during the period was below forecast?

The ACCC needs to ensure that Transend provides a watertight justification for this, as it will inevitably result in higher transmission prices for all Tasmanian customers. We are also concerned that should this upward revision be simply accepted, what is to prevent Transend from doing so again in the middle of the next regulatory period in time for the following review? That the Tasmanian Government, as owner of Transend, approved this upward revision of asset values only adds to our discomfort (see section 4).

Table 1 shows that this difference in the Regulatory Asset Base amounts to some \$91M in nominal dollars after taking into account the impact of lower actual capex, estimates for depreciation, and inflation.

3 CAPEX

In 1999, OTTER stated that Transend's forecast of capex between June 2003 and June 2009 was at \$167.5M. In its current application, Transend's forecast capex between January 2004 and June 2009 (a six month shorter period) was at \$330.8M, an increase of almost 100%! Removing the period January to June 2003, the increase in capex is from \$112.3M to \$304.1M, an increase of over 170%!

In addition, Transend had not incurred the capex approved in the previous OTTER price determination, yet seeks substantially increased capex relative to the previous forecast capex.

This seems a highly questionable request that could expose energy users to an excessive level of capex over the next regulatory period. Transend should be required to provide a detailed statement of scope and timing for proposed capex and have this subjected to detailed scrutiny by suitably qualified engineering consultants. This should identify the purposes for this expenditure and provide a proper allocation of costs to the respective beneficiaries of each project or class of development work. This will enable the ACCC to critically assess these claims and set a capex level that is both justified and feasible. It would also allow the energy market participants in Tasmania to assess their exposure to any increase in costs and to confirm whether or not offsetting benefits exceed any increase in costs.

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Transend did not keep pace with its previous capex program, a program of an order of magnitude lower than what it seeks in its application to the ACCC. The large discrepancy between projected and actual capex in the current regulatory period also brings into question:

- the basis for the original forecast of capex;
- the competence of Transend's forecasting and planning processes; and
- the possible exercise of 'strategic behaviour'.

Table 1 Comparison of Asset Values

	OTTER Approved (\$M)				Application RAB	RAB Difference
	1998/99	1999/00	2000/01	2001/02	2002/03	
Opening Asset Base	333.3	378.2	406.3	433.3		
add Capex	59.6	48.0	42.9	52.2		
less depreciation	14.5	15.2	15.9	16.8		
less disposals		4.8				
Closing Asset Base	378.4	406.3	433.3	468.7		
Inflation @ 2.6%	388.2	427.7	468.0	493.4	542.2	48.8
Actual \$M						
Opening Asset Base	333.3	382.7	399.2	423.1		
add Capex	54.0	36.2	28.7	32.5		
less estimated depreciation ³	14.3	14.9	15.5	16.0		
less disposals		4.8				
Closing Asset Base	373.0	389.8	412.4	439.6		
Inflation @ 2.6%	382.7	399.2	423.1	451.0	542.2	91.2

The ACCC needs to examine all of these issues. For example, a key issue that needs to be made transparent is what portion of the previously forecast capex was associated with the delayed Basslink project and what portion of the current forecast capex remains Basslink related. Figure 1 shows Transend's capex actual and forecast values as reported in the current and previous applications. On the surface, it appears that some of the underspend may be associated with the delayed Basslink project and there is a risk that this expenditure

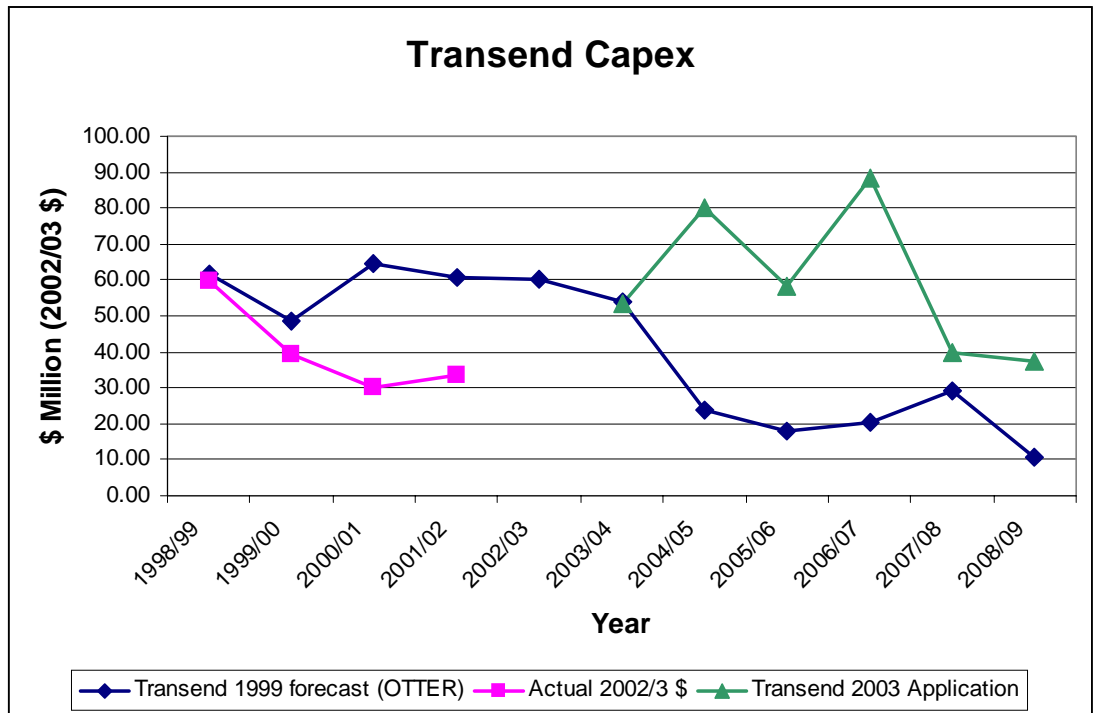
³ Lower Capex incurred should lead to lower depreciation. Estimate based on difference in forecast and actual capex incurred over a 25 year economic.

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could be included in the forecasts for the future. We seek clarification on this point and would object strongly if there was any ‘double dipping’ associated with Transend’s capex.

Transend has also identified a number of generation driven variable projects in its revenue application. We submit that given that these projects are clearly generation driven despite the fact that capital works are required to be performed on the shared network, the costs of these projects should be allocated and charged directly to the generator rather than requiring customers to pay for them in the form of TUoS charges.

Figure 1 Transend Capex



4 INCENTIVE

In its Revenue Cap Application, Transend seeks an increase in its allowed revenue to compensate for committing more resources to regulatory issues in the current regulatory period as well as costs relating to Tasmania’s entry into the NEM. We believe that this request is highly inappropriate given that the incentive regime allows Transend to keep any gains from lower expenditure across regulatory periods. Since unforeseen lower costs are not “clawed back” in subsequent regulatory periods, it would not be appropriate for similarly unforeseen higher costs to be compensated in subsequent periods. Failure to keep this balance would mean that customers would be faced with an asymmetrical risk. Acceding to this request would mean that Transend (and other regulated TNSPs) would face only upside risk where

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unexpected higher costs are underwritten by customers while the benefits of unexpected lower costs are kept by the regulated entity, Transend.

Customers were exposed to the high forecast capex that was not spent between 1999 and 2002. Transend, in its current application, is requesting an even higher forecast capex spending to be approved. Should this occur, Transend would have virtually unlimited resources to expand or gold-plate their network with little consideration of their relative efficiency merits.

On the other hand, should the spectre of a fall in network performance be used to justify a higher capex in the next regulatory period, the one question to be asked is, “why capex was so drastically under spent in the current regulatory period compared to that forecast previously?”

Our analysis, however, does indicate that Transend’s actual capex between 1998/99 and 200/02 is in line with other NEM TNSPs’ capex, based on three to five year growth in peak demand, energy delivered and the sum of import capacity and generation capacity installed (see section 9). Accordingly, in hindsight, it is the previous forecast level of capex that is excessive and some form of incentive should be available for TNSPs to get their forecast level of capex right and to identify the market drivers and forecasts, which provide the basis for its justification. This is an important issue for the ACCC to consider given the almost universal increases in capex being requested by energy networks.

It should also not escape the attention of the ACCC, that capex is one of the regulatory parameters most susceptible to regulatory gaming by TNSPs.

Also a significant incentive anomaly and conflict of interest arises when the ACCC is required to accept a jurisdictional decision regarding the regulatory asset base when the jurisdictional decision maker is also the sole shareholder of the regulated TNSP. On the basis of Transend’s application, Tasmanian customers could well end up paying significantly more in transmission charges due to the very large increases in regulatory asset base put in place by the Tasmanian Government, who would benefit from the increased dividend from Transend.

5 WEIGHTED AVERAGE COST OF CAPITAL

We provide some comments on specific components of WACC in the following sections.

5.1 Cost of Debt

Transend (and its consultant, NECG), makes much of the impact of the bond yield period on the cost of debt, arguing that the ACCC should adopt 10-year bond rates as the basis for estimating the ‘risk free’ cost of debt. The impact of bond period has been examined by regulators in the UK, which has lead to the conclusion that bond yield period is not a critical factor provided that estimates of inflation are based on data related to the bond yield period.

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Transend (and NECG) has used yields on nominal and capital indexed government bonds of similar maturity, but only references the 10 Year Bond rates, and provides no comparison with estimates of Cost of Debt or WACC using equivalent (or estimated) 5 Year Bond rates. Given the (approximately) five yearly regulatory cycle, it is more appropriate for 5-year bond rates to be used as refinancing can occur to coincide with the regulatory cycle. UK experience suggests it would be reasonable to expect that the 5 year bond rates would prove to be a few basis points lower than the 10 year bond rates and inflation estimates, thus leading to only a slightly lower WACC.

Why should the bond yield period be different from the regulatory period under consideration?

5.2 Debt Margin

In its application, Transend is proposing a Debt Margin of 1.445%. This is 22.5 basis points higher than debt margin the ACCC allowed for SPI PowerNet and Powerlink, and 44.5 basis points higher than it allowed for TransGrid. The ACCC allowed a debt margin of 1.22% for ElectraNet. There is no consistency in these values, and no satisfactory explanation for the differences in the relevant ACCC decisions.

We seek a consistent approach with substantiated reasoning on this matter.

5.3 Market Risk Premium (MRP)

Transend (and NECG) argues for MRP values higher than 6%, but bows to regulatory precedent and adopts 6%, as have all Australian regulators - based on backward-looking historical data. NECG relies on Lally's vague comment that MRP can be any value between 4% and 7% (p 21, Appendix 7) and settles on 6% with little theoretical or empirical justification besides regulatory precedence. This cannot be a sound basis for determining a major WACC parameter that will inflate Transend's revenue and hence transmission charges to Tasmanian customers.

Australian regulatory authorities should note that UK regulators have all adopted (around) 3.5% based on forward-looking market views (and judgments).

We also note that there is a logical inconsistency of looking forward for all other values used for Capital Asset Pricing Model (CAPM), yet looking backwards for MRP. UK regulators have all accepted that this logical inconsistency is inappropriate and it is time for Australian regulators to do the same.

We ask the ACCC to consider adopting the forward-looking approach in its final determination.

5.4 Asset Beta

NECG produces data that clearly shows Asset Beta and Equity Beta for (supposed) comparators being at or (well below) 1.00 and then recommends adopting values substantially

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above 1.0 on the basis that "We are different to all the others" and "These differences create greater/asymmetric risk for our business".

No regulators in the UK or US accept that any regulated energy company faces more risk than the share market as a whole, with UK regulators adopting values of 1.00 as maximums for Equity Beta.

What convincing justification does Transend provide for adopting a value of Beta above 1.00?

5.5 WACC Conclusion

We have analysed recent 'claims' by Australian utilities and decisions by various regulators in respect of WACC outcomes. These are attached in Appendix A to this submission.

In essence, Transend proposes:

- Cost of Debt (Real) of 4.65%, about the 'middle of the pack' and some 40 basis points higher than the ACCC endorsed for ElectraNet SA and SPI PowerNet.
- Return on Equity (Real, post-tax) of 9.82%, significantly higher than proposed by SPI PowerNet (by Officer), but otherwise lower than other 'claims'. This is about 90 basis points higher than the ACCC endorsed for ElectraNet SA and SPI PowerNet.
- WACC (Vanilla, Real, Post-tax) of 6.72%, slightly below all other 'claims' by utilities, but still around 60 basis points higher than the ACCC endorsed for ElectraNet and PowerNet.

This continues the (expected) trend of 'strategic behaviour' for Australian utilities, and maintains the "unexplained" gap between the cost of capital for Australian utilities compared to the UK and US utilities.

Customers are still seeking an, as yet, unanswered question posed to the ACCC in the EUAA's submission on SPI PowerNet and ElectraNet:

"Should/do financial markets see Australian utilities as being 'less efficient' or 'more costly' than their UK and US counterparts, particularly when other capital-intensive (but unregulated) Australian companies are able to be competitive internationally for capital and debt funding?"

We believe that the answer to this question is that they do not, but for some reason that has never been adequately and transparently explained regulators persist with decisions that suggest the opposite and are out of step with financial markets.

In conclusion, Transend has applied for a nominal post-tax WACC of 8.8% (or a real, post-tax "Vanilla" WACC of 6.7%). The ACCC in their two most recent TNSP revenue decisions for SPI PowerNet and ElectraNet approved a nominal post-tax WACC of 8.23% and 8.3% respectively (6.1% real, "Vanilla"). Little has changed in the economic environment since these two decisions were handed down, nor is there sufficient difference in TNSP specific characteristics to justify an increase of 50 basis points for Transend. Moreover, the values proposed by Transend are still some 100 basis points higher than judged 'efficient' for UK (and US) utilities.

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The revenue impact of this increase of 1% is around \$5M in 2002/03, rising to over \$7M in 2008/09, should Transend regulatory asset base and Capex forecast be accepted. This will have an impact in higher transmission charges in Tasmania, which end use customers will have to pay for.

There is no apparent reason why Tasmanian electricity users should pay higher transmission charges than in other states, which will impact adversely on their competitiveness, merely to allow Transend, a monopoly supplier, to earn unjustifiably high returns.

6 OPERATION AND MAINTENANCE EXPENDITURE

In 1999/2000, OTTER approved O&M expenditure of \$17.75M for Transend. This increased to \$18.34 and \$18.32M in 2000/01 and 2001/02, respectively. Transend has applied for O&M expenditure of \$33.4M in 2004/05, rising to over \$36M in the following two years and over \$35M in each of the two years after that.

This amounts to increases of almost 100% over two regulatory periods. Even after taking into consideration any increased costs associated with NEM entry, this is clearly a very large increase in O&M expenditure especially when the OTTER approved O&M expenditure, over the previous regulatory period, includes costs associated with System Control, which is expected to be transferred to NEMMCO. This may be an indication that Transend has become grossly less efficient over these two regulatory periods, or that Transend is engaging in 'strategic behaviour'. Either way, Transend should not be rewarded either for inefficiency or alternatively, for O&M expenditure forecast that are not reasonable.

Accordingly, Transend's O&M expenditure needs to be examined closely by the ACCC and pared back significantly to reasonable and efficient levels before customers would accept it.

Transend has also identified a number of new generation and Basslink driven variable O&M cost changes in its revenue application (p. 70). We submit that, given that these costs are clearly not driven by customers requirements, but by new generation and Basslink requirements which will affect the quality of supply as well as increase the complexity of the system (eg due to the intermittent nature of wind generation), they should be allocated and charged directly to the generators or Basslink rather than requiring customers to pay for them in the form of TUoS charges.

We also fail to see why any increased costs should be incurred by Transend with the unwinding of vesting contracts on the basis of increased customer enquiries. In Tasmania where the number of large customers are limited, Transend should be able to handle any increased customer enquires for direct connections fairly easily. But even if it does lead to increased costs, general customers (including domestic customer who would never make such enquiries directly to transmission companies) should not have to bear this burden in the form of increased TUoS charges. The costs can be recovered from customers making enquiries in the form of excluded service charges.

7 PERFORMANCE STANDARDS

The EUAA and EAG believe that it is important that electricity users in Tasmania obtain an acceptable level of service from the transmission system. We welcome the steps the ACCC has taken to date in requiring TNSPs to implement some (limited) service standards, but believe that further steps are urgently needed to put into place a more effective and meaningful system of (positive and negative) incentives. The imminent entry of Tasmania into the NEM makes this even more important in the case of Transend.

The ACCC would be aware of our strong views on the need for regulated transmission entities to be provided with (positive and negative) incentives for service standards, particularly related to the impacts on the energy market (eg due to outages for scheduled maintenance). This is axiomatic given the large impact, relative to transmission costs, that the actions of transmission companies can have on energy prices.

The EUAA/EAG have also previously recommended that performance incentives for transmission entities would be more effective if applied uniformly across the NEM. Completing reviews and revenue re-sets for all regulated TNSPs at the same time would do this best. This highlights, once again, that the current arrangement of piecemeal review of individual TNSPs at different times is costly, inefficient and substantially reduces the benefit to end users of regulation. The ACCC is permitted significant discretion in the Code that would allow the alignment of regulatory reviews for all TNSPs at the same time.

The EUAA and EAG once more call for the ACCC to act on this matter.

7.1 Performance incentives

In its previous two revenue cap decisions (PowerNet and ElectraNet), the ACCC has placed 1% of allowed revenue at risk for under performances. This implies that 99% of the TNSP's revenue is assured, or guaranteed, regardless of the level of performance. In the extreme event that Transend's performance deteriorates dramatically, customers are still required to fund 99% of the allowed revenue. While there may be other considerations (eg political) that may prevent this from happening, clearly the financial incentive of placing just 1% of revenue at risk is inadequate. Based on its pre-revaluation equity of \$395M, Transend's return on equity in 2004 would be over 15.7% before tax should the revenue applied for be approved. Placing 1% of revenue at risk would only lower this return to 15.5% in the worst case. Certainly, this is an investment any investor would clamour for if this application and an inadequate financial incentive for Transend to ensure that it maintains and improves its level of service.

On a related issue, Transend and other TNSPs are generally regulated via a revenue cap. As such, these monopolies face little, if any, volume risk both in terms of energy, maximum demand and customer numbers. Should a customer reduce electricity consumption due to lower production or closure of the business, all other customers will have to pay more transmission charges to "compensate" for the reduced revenue caused by losses from this

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large customer. In the event that a large customer leaves (eg a mine ceases operations), the cost of transmission services for other customers would rise substantially to restore Transend's revenue target. Even if Transend's performance falls and the quality of its services deteriorates leading to a lower demand, Transend's revenue, under this regulatory environment, is assured. This provides very little incentive for Transend to produce a quality product to retain customers and maintain volume.

This is in contrast to price caps faced by some distribution Network Service Providers (eg in Victoria), whose regulated charges are based on average prices. These distributors at least face the prospect of lower revenues should volumes, demand or customer numbers fall below forecast.

In its application, Transend also states that three of the five performance indicators that the Commission proposes to use to form the basis of a TNSP performance incentive scheme are inappropriate, viz *restoration times after outages*, *intra-regional constraints* and *inter-regional constraints*. While we understand that Basslink is a Market NSP and, as such, *inter-regional constraints* are inappropriate for Basslink (though not necessarily for Transend's portion of the link), we fail to see the reason for not including the other two measures.

Transend indicates that past performance for *restoration times after outages* is "volatile as a result of a small number of significant events" and uses this as justification that "an appropriate target and incentive mechanism cannot be developed". We are of the opinion that it is precisely because past performance shows that such a measure is critical. While the number of events may be small, they can be very significant to customers when they occur. In the extreme, should just one event occur but lasting a number of days, weeks or months, this is clearly unacceptable.

On intra-regional constraints, Transend cites insufficient past data and a limited ability to control performance. If a TNSP is unable to control constraints on its network, then perhaps its capabilities as a network service provider needs to be questioned. Surely appropriate investments in relieving network constraints can be made or demand management measures can be taken. Also appropriate pricing signals to generators to locate in areas so that constraints can be relieved can be used to solve this problem. In this regard, we understand that a number of proposals have been made to site waste to energy generators to the south of Hobart, which will have the potential to relieve certain intra-regional network constraints, but have not been entirely welcome by the network service provider.

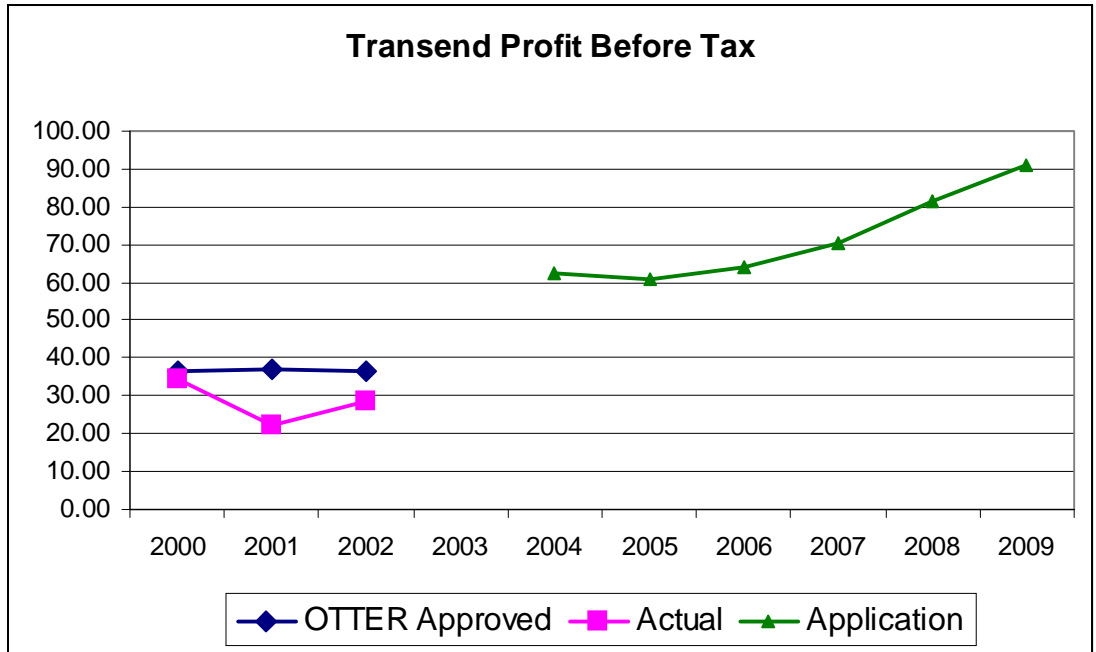
Also, having insufficient past data should not be a reason that this measure is discarded. If Transend does not know its network sufficiently to assess its past performance on constraints perhaps benchmarks can be set based on inter-state comparison. In any case, a start should be made to collecting such data now.

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8 BUSINESS PERFORMANCE

Figure 2 shows the OTTER approved profit before tax (in 2002 dollars) compared with the actual profit achieved by Transend as reported in its Annual Reports. OTTER's decision in 1999 envisaged Transend achieving profit before tax in the vicinity of about \$35 pa between 2000 and 2002. While Transend met expectations in 2000, it fell below expectations in 2001,

Figure 2 Transend Profit Before Tax



achieving a profit before tax of under \$22.5M. Transend's profit recovered towards the approved level in 2002 at over \$28.5M. Figure 2 also shows that, should its revenue application be approved, its 2004 profit before tax will more than double its profit level of 2002. Profit will continue to climb at an average rate of almost 8% pa between 2004 and 2009, so that by the end of the regulatory period in 2009, its profit will have more than tripled its 2002 level in real terms. It is difficult to envisage another entity in a stable mature competitive environment where profits can be tripled in a matter of 7 years.

9 COMPARISON OF TASMANIAN ELECTRICITY TRANSMISSION

The following charts show various aspects of Tasmania's transmission network compared with the transmission network in other Australian states. Figure 3 shows that Tasmania's electricity transmission prices have been increasing between 1998/99 to 2001/02, while average transmission prices have been falling in other states. On the basis of the revenue application, the Tasmanian average transmission price will increase sharply in 2003/04 and continue to

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increase till the end of the regulatory period. With this increase, Tasmanian transmission prices will be, on average, the second highest price in Australia, which will not assist the already difficult state of Tasmanian economic development. It is of significant concern to energy users in Tasmania.

Figure 3 Average Transmission Prices

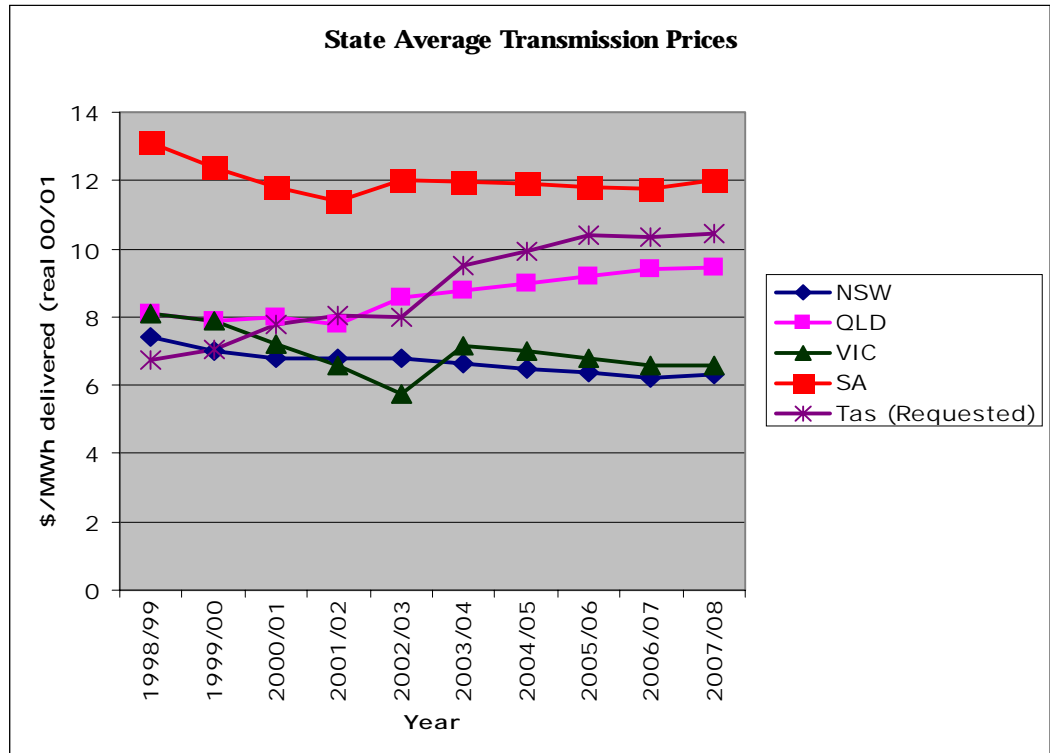


Figure 4 shows the transmission O & M cost component of each MWh delivered to customers. As it stands, the Tasmanian transmission O&M cost proportion is substantially higher than that in the other NEM states, except for South Australia. With the revenue application requested, the O&M component will approach the levels seen in South Australia, approximately 1.5 cents per MWh higher than the next highest, Queensland. This may well indicate that, rather than improving its efficiency, Transend's operational efficiency is deteriorating. This is further reinforced by the subsequent two figures, Figure 5 and Figure 6, which shows that Tasmania's O & M costs, as a proportion of both Transend's Asset Base and as a ratio to peak load, will be higher than any other NEM TNSP. Therefore, Transend may well be the most inefficient TNSP in the NEM and its customers should not be penalised further with even higher O&M costs in the next regulatory period.

Figure 4 O&M Costs

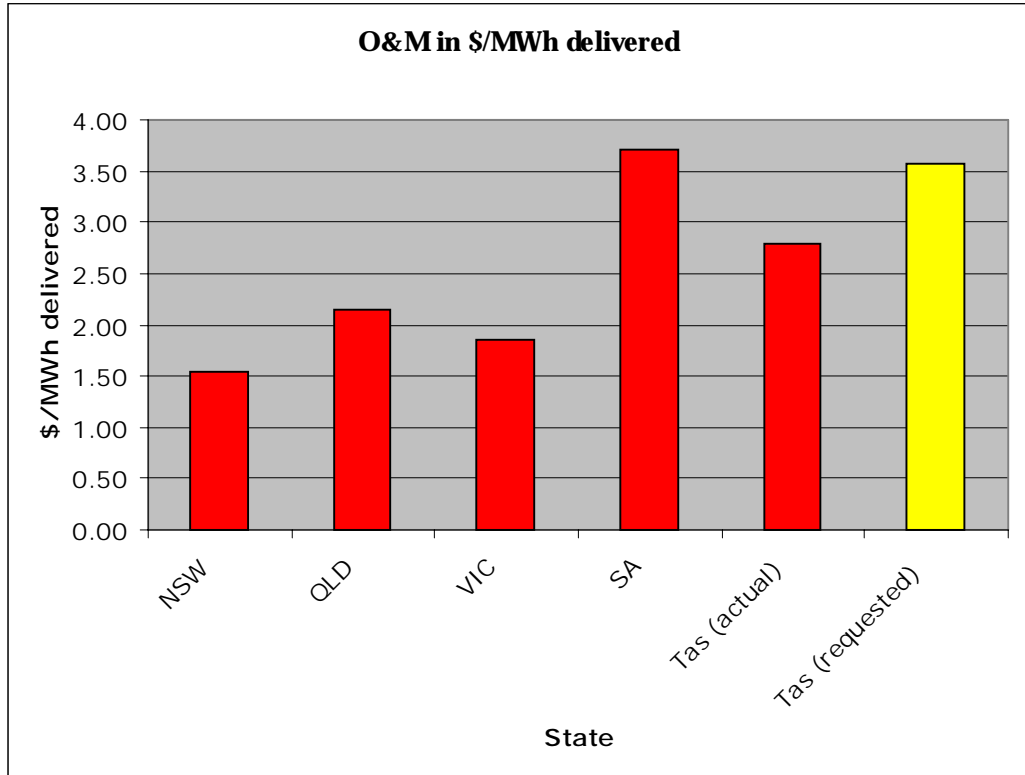


Figure 5 O&M as a proportion of Asset Base

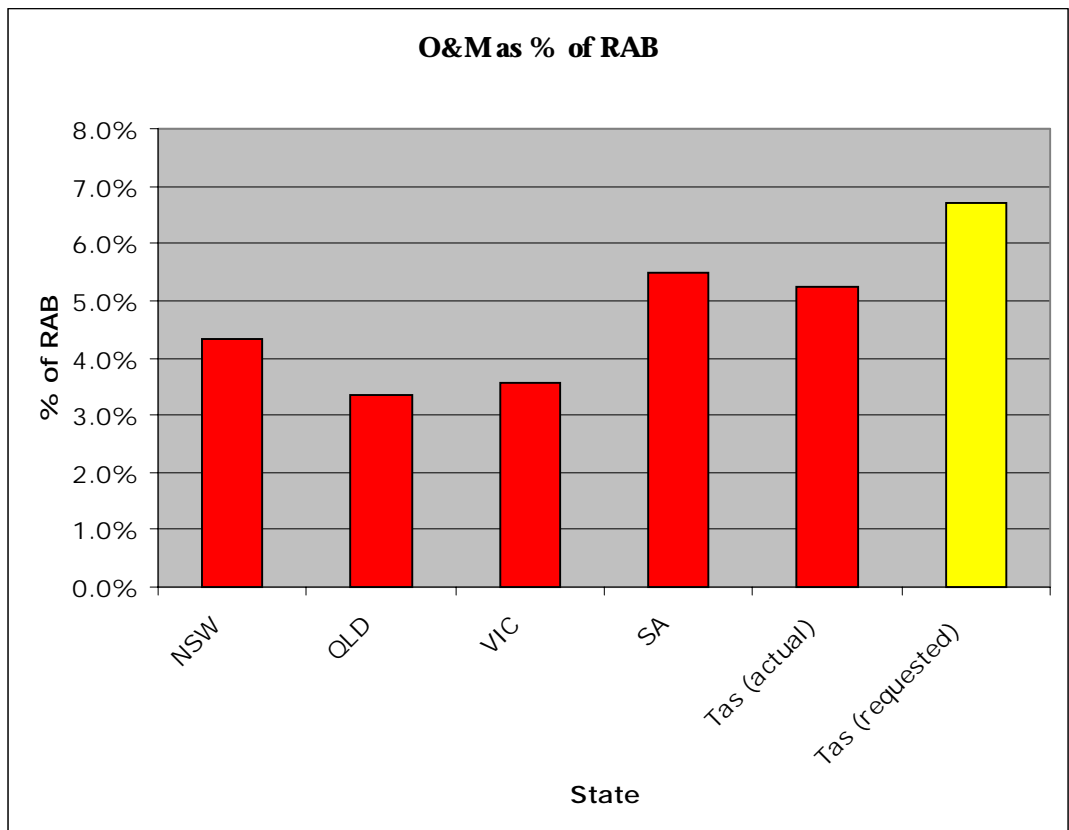
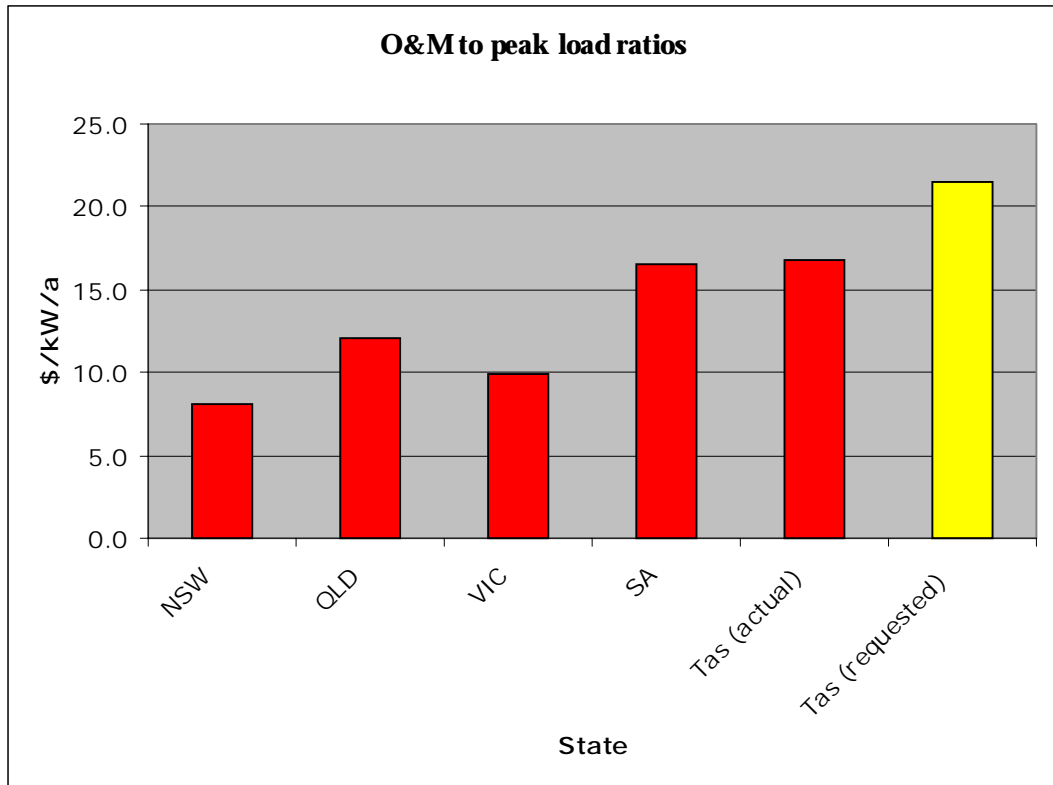


Figure 6 O&M to Peak Load



With its current actual capex spend, Transend is not misaligned compared with most other Australian states, exceeding only PowerNet as a proportion of its asset base. However, with its application, capex as a percentage of asset base will increase to substantially higher levels than all NEM states. This is despite a substantial increase in its asset base as discussed in Section 2.

Further analysis was undertaken on Transend's actual and requested capex as a proportion of its Regulatory Asset Base in comparison with the other NEM states and normalised to take into account growth in peak demand, energy and the impact of generation and import capacity growth (including the impact of Basslink).

Figure 8 and

Figure 9 shows that Transend's capex to RAB ratio is not consistent with the capex to RAB ratio of the other NEM states when normalised for peak demand growth and energy delivered. In both cases, it can be seen that, while historical actual capex is within the range expected in comparison with the other NEM states, the requested capex is significantly above the levels that can be expected based on forecast maximum demand and energy growth. This suggests that the additional capacity is associated with targets for renewable development and the works to accommodate Basslink.

Figure 7 Capex as a proportion of Asset Base

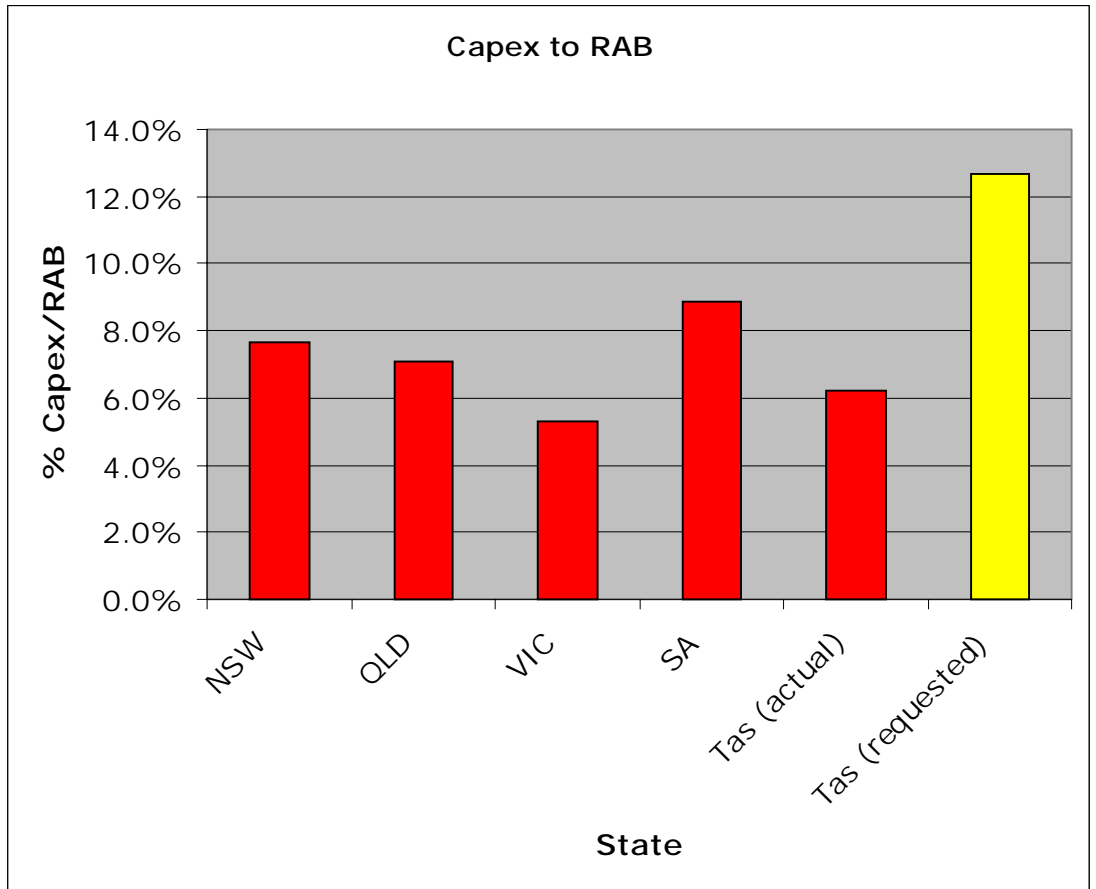


Figure 8 CAPEX to RAB normalised to Peak Demand Growth

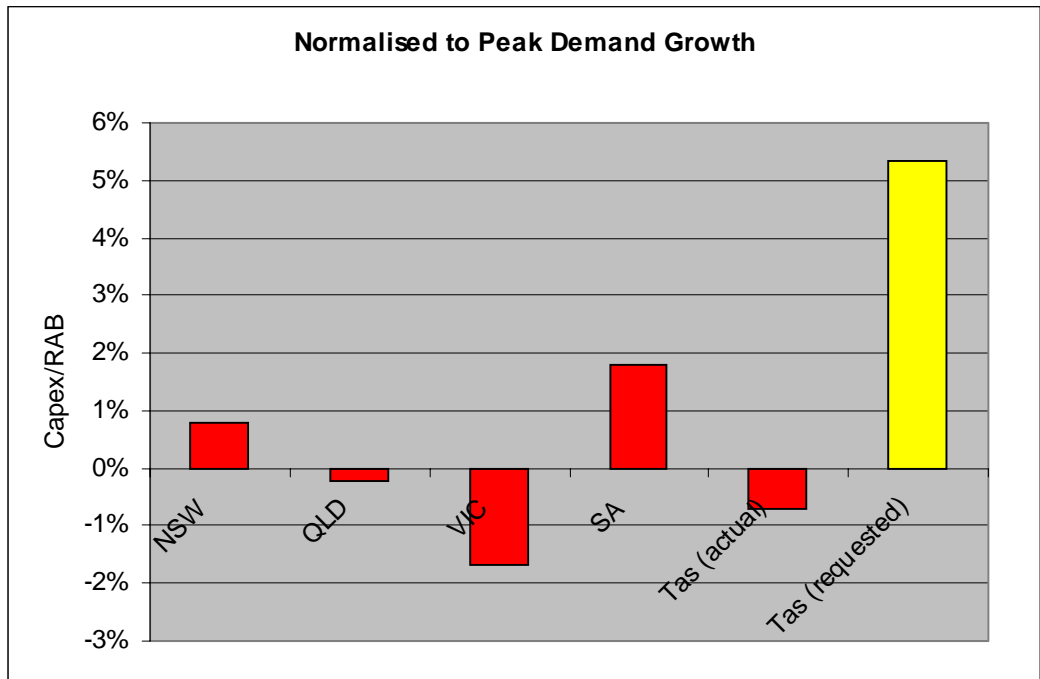
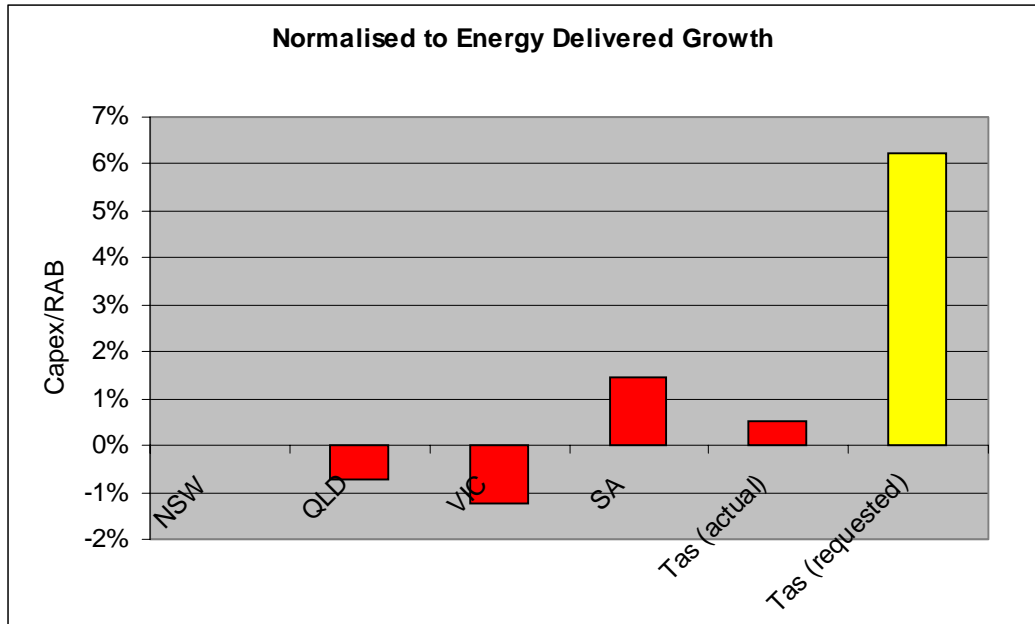


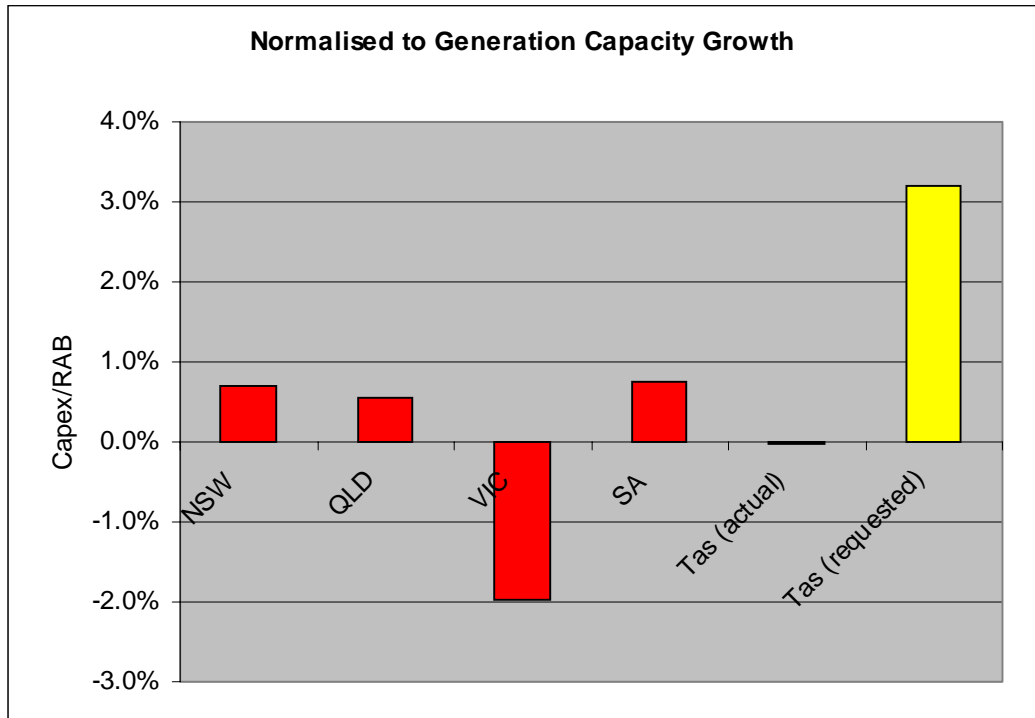
Figure 9 CAPEX to RAB normalised to Energy Delivered Growth

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We also sought to explain the requested capex growth by normalising with respect to increases in connected generation and import capacity as indicated by Transend in its application. The distinction we made here is the difference in Basslink import and export capacity (which is 300MW and 600MW respectively). When normalised against Tasmania's expected capacity increase including the 300MW import capacity by Basslink, the requested capex still shows significant misalignment when compared with the other NEM states.

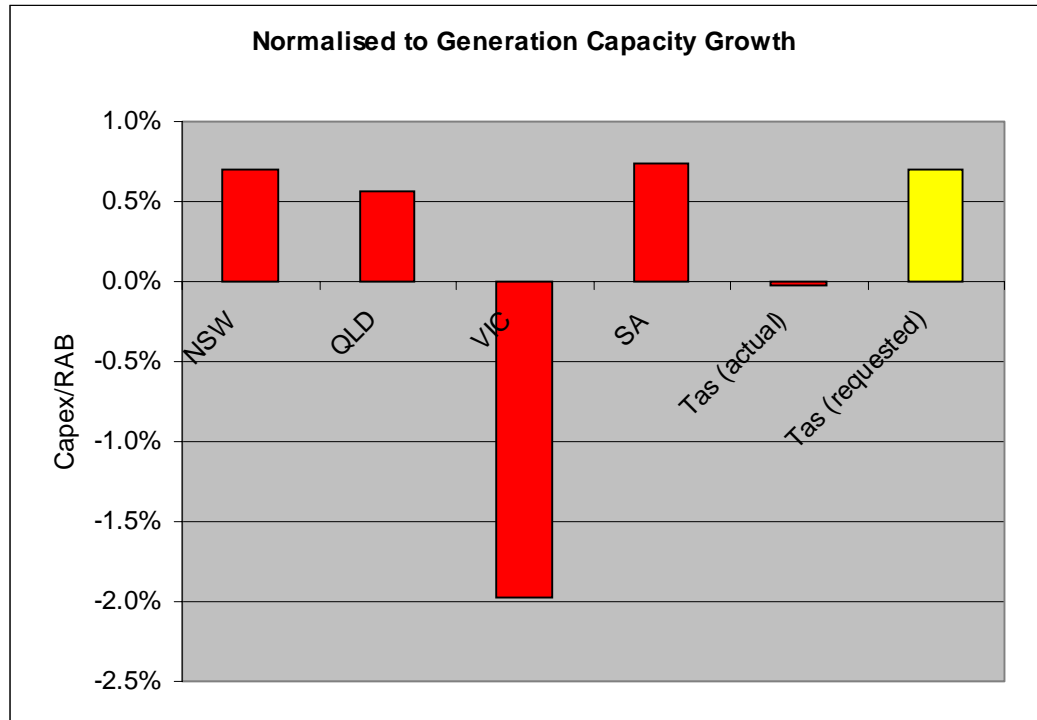
Figure 10 CAPEX to RAB normalised to Generation Capacity Growth with Basslink Import of 300MW



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When a similar analysis was undertaken based on Basslink's export capacity of 600MW, Transend's capex falls into line with the other NEM states. This indicates that Transend's requested capex is based largely on the expected capacity growth and that most (if not all) of the excessive capex can be explained by the development of Basslink.

Figure 11 CAPEX to RAB normalised to Peak Demand Growth with Basslink Export of 600MW



The impact of this analysis is that Tasmanian customers should not be required to fund the excess capex, which is clearly a Basslink export related cost. Beneficiaries of the Basslink export capacity (ie, Hydro Tasmania and National Grid International) should shoulder this burden instead of Tasmanian electricity customers.

Requiring Tasmania customers to bear this burden would mean that customers will be faced with a "double whammy" of cost increases. Given the nature of the Tasmanian electricity system, with the establishment of Basslink, Tasmania would be expected to export energy during peak period, while importing during off-peak periods to conserve water resources for peak period electricity production. Peak prices can be expected to rise, while off-peak prices may fall. Overall, we expect that energy prices to Tasmanian customers will rise with the establishment of Basslink. If customers were then also be required to fund Transend's Basslink related costs, it would be grossly unreasonable given the limited direct benefit that would flow to customers from its establishment.

10 MARKET DEVELOPMENT IN TASMANIA

There are four additional matters that should be assessed by the ACCC in relation to the future development of the electricity market in Tasmania:

- The extent to which Basslink operation requires additional investment to manage the increased power flows in the Tasmanian transmission system;
- The extent to which the development of wind power will similarly impose additional capital costs;
- The extent to which future operating costs incurred by Transend will ultimately be transferred to NEMMCO when the NEM commences in Tasmania; and
- The extent to which the plans of Transend have made provision for the support of distributed generation or demand management that could defer capital expenditure in the network.

10.1 Basslink and Wind Power

A major potential source of additional capital investment would be associated with Basslink and with the expansion of wind generation. Both of these developments will change power flows on the Tasmanian network significantly and increase the effect of existing transmission constraints on the Tasmanian energy market. For example, the daily cycle of import and export across Basslink will affect power flow north and south. The development of wind farms on the west coast will increase power flow variation from east to west on a daily basis. It is possible that such developments would reduce maintenance windows throughout the Tasmanian network and lead to increased capital and maintenance expenditure.

It is therefore reasonable to expect that investment in the shared network will be associated with the variation of power inputs from wind power and Basslink that is not directly related to customer demand. It is not clear how much of the proposed additional capex is related to replacement of old assets and how much is associated with these generation developments.

In pursuit of the principle that “causer pays”, the transmission costs that are incurred to accommodate the additional generation and which are not related to load growth or variation, should be allocated to the generation projects that require that investment.

For this reason, a clear and transparent assessment of the basis for this increase in capex should be required by the ACCC.

10.2 NEM Operation

The role of the system controller, which is currently under the auspices of Transend, will eventually be taken over by NEMMCO when the NEM is extended to Tasmania.

ACCC should ensure that such costs are separated from other Transend costs so that transmission tariffs can be adjusted when these costs become part of NEM fees. Otherwise, end-users would be required to pay twice and pay Transend for a function it no longer

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undertakes. Whether or not this has been taken out of the Transend application is not clear (we could find not evidence that it had been) but the answer needs to be established and made transparent.

10.3 Support of Embedded Generation and Demand Management

It is known that there are several possible small scale embedded generation projects that could be developed in Tasmania which would off-load or support the network under heavily loaded conditions. Proponents have apparently had some difficulty in negotiating appropriate terms and conditions that recognise the benefits of their projects in avoiding or deferring future network investments. In principle, such small and medium scale generation projects could receive compensation to encourage their development and economically defer investment in the network. This is especially so in the southern region which will need reinforcement in the next few years. There is no evidence in the submission of an appropriate planning strategy to address these opportunities, to take competing options into account (as is required under the NEM Code), or to allow a provision for costs to facilitate this network support. It is possible that forecast capital expenditure has been over-stated because the opportunity to economically defer transmission capital expenditure with embedded generation projects (or demand management) that have other market benefits has not been properly assessed.

Transend should be required to address these issues in a clear and consistent manner.

11 SUMMARY AND CONCLUSION

The EUAA and EAG believe that Transend's application grossly inflates their revenue requirements. Transend has made ambit claims against many aspects of the building blocks approach including:

- The Regulatory Asset Base has been unreasonably revalued from the level accepted by its current regulator, OTTER.
- Capex has been underspent in the current regulatory period, yet Transend attempts to seek even greater allowance of capex in the next regulatory period.
- On most benchmark measures of capex, Transend's application is seen to be higher than other comparable TNSP and it is only where Basslink's export capacity is included can its applied capex be justified.
- The WACC applied is at least 50 to 100 basis points above a reasonable level.
- Opex increases amount to almost 100% over the current regulatory period and may indicate that Transend has become less efficient, or is exercising "strategic behaviour".

EUAA and EAG also submit that:

- The process of completing revenue reviews and re-sets for all regulated TNSPs at the same time, would best provide for consistent regulatory approaches to TNSPs across the NEM. Transend's attempts to avoid scrutiny on a number of performance indicators on spurious grounds would then be more clearly evident.

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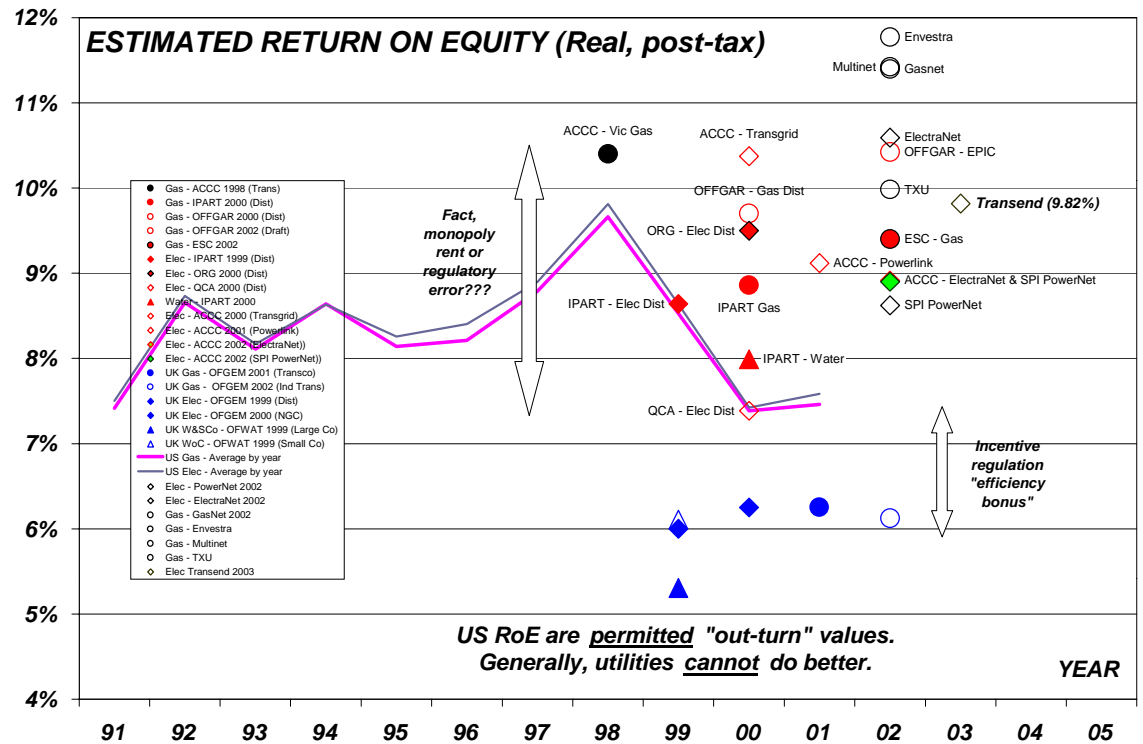
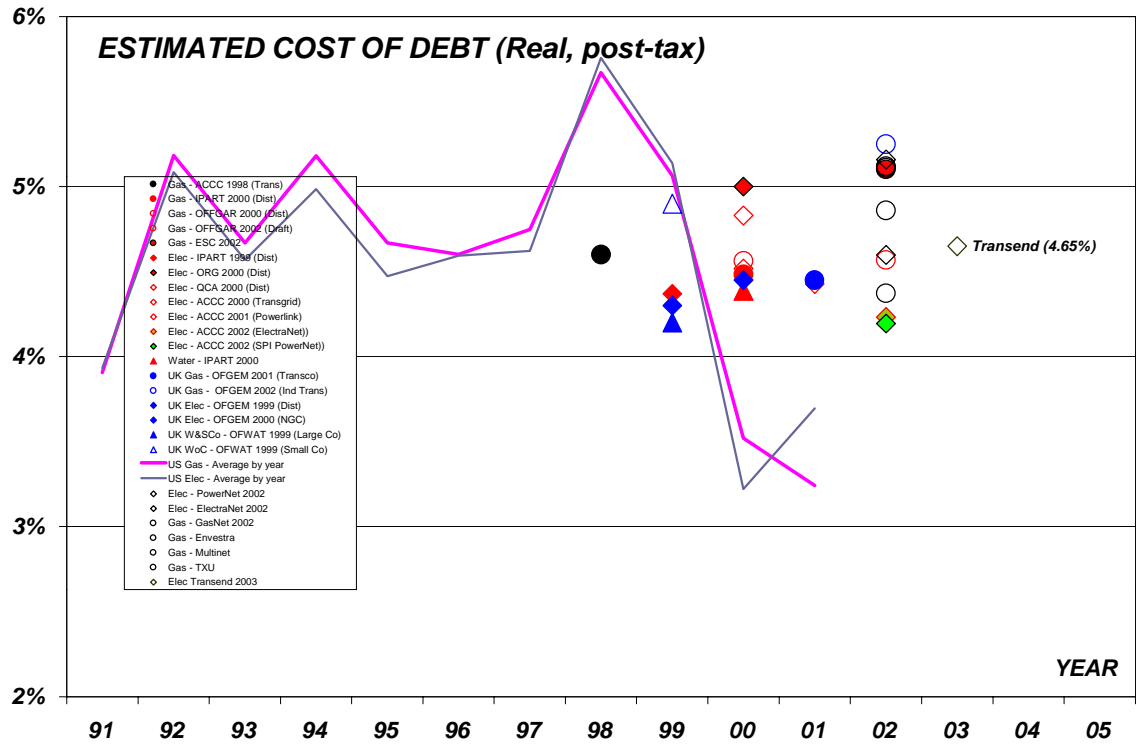
- A 1% revenue at risk, as proposed as a service incentive, is surely insufficient incentive for such an organisation. Based on its pre-revaluation equity of \$395M, Transend is seeking to achieve a return on equity of over 15% in 2004. A 1% reduction in revenue does not make a significant impact on such a high level of return on equity.
- A monopoly service provider's attempt to triple its profit before tax over 7 years must be seen as unreasonable and an attempt to exploit its monopoly power.
- Transend's performance standards in servicing its 'customers' are of utmost importance to end use customers, who are required to pay virtually all TuoS in the NEM, and as such meaningful incentives to maintain and improve performance are required.

Users will need to be satisfied that the concerns expressed in this submission have been adequately addressed. In particular:

- How is it possible that the value of the asset base could have increased over the regulatory period by a greater amount than the capex before even taking depreciation and disposals into account?
- How can Transend, or its shareholder (or for that matter any other NSP), simply review upwards its RAB before a revenue setting review to increase its allowed revenue?
- Why was Transend's capex so drastically under spent in the current regulatory period compared to that forecast during the OTTER approval process?
- Why should the bond yield period used in the revenue cap application be different from the regulatory period under consideration?
- Why should/do financial markets see Australian utilities as being 'less efficient' or 'more costly' than their UK and US counterparts when determining their cost of equity and debt, particularly when other capital-intensive (but unregulated) Australian companies are able to be competitive internationally for capital and debt funding? How can a market risk premium nearly double that applied by overseas regulators to energy utilities be justified?
- What justification does Transend provide for adopting a value of asset Beta above 1.00?
- Will Transend's O&M expenditure be examined closely to ascertain if it is at reasonable and efficient levels given that they have applied for an increase of almost 100%?
- Why are there increased costs incurred by Transend with the unwinding of vesting contract when they do not have significant dealings with end use customers?
- Will the performance incentives for transmission entities be applied uniformly across the NEM? Why should Transend not be required to submit to a meaningful (positive and negative) performance incentive regime during the next regulatory period?
- How much of the increase in CAPEX AND OPEX is driven by the connection of Basslink and wind power and is largely unrelated to the growth in forecast demand?
- Why should Tasmanian electricity users pay transmission charges that would be the second highest in the NEM and include clearly inefficient costs?
- What provisions have been made to support embedded generation/demand management and defer less economic transmission upgrades that have higher cost and market risk?
- What portion of Transend's costs are related to the future operation of the NEM in Tasmania, which will be transferred to NEMMCO during the regulatory review period?

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APPENDIX A: COMPARISON OF WACC OUTCOMES



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