ACCC Transend Revenue Cap for Tasmanian Transmission

Submission on the Draft Determination

October 2003

TABLE OF CONTENTS

Page No.

TRANSEND REVENUE SUBMISSION TO ACCC

1 INTRODUCTION

The Energy Users Association of Australia (EUAA) values the ACCC's involvement in regulation of monopoly transmission network service (TNSPs) in the National Electricity Market (NEM) and the public review processes undertaken by the Commission.

Unfortunately, the ACCC's Draft Determination on Transend's revenue cap application for transmission in Tasmania has failed customers. This is our assessment based on the Draft Determination and comments provided at the ACCC's public forum in Hobart held on Friday 17th October.

One of the stated objectives for the ACCC is to emulate competitive outcomes. On page 46 of its Draft Determination, the ACCC states that its "regulatory regime tries to replicate a competitive market". We would like to know which competitive market enables a company to organically increase its revenues by over 60% in real terms over a five year period resulting in average price increases of about 10% per annum. Excessive price increases such as this would only be possible in a monopoly market that is **unregulated**.

Which competitive market allows a company to triple its EBIT (in the absence of mergers or acquisitions), while at the same time experiencing deteriorating efficiency levels evidenced by escalating O&M costs?

In competitive markets, capital investments must be justified either by increased output or reduced inputs, yet Transend is allowed to double both its capex and opex within an environment where little if any load growth is taking place.

The Draft Determination hardly replicates a competitive market!

This very generous regulatory Draft Determination fails to deliver competitive outcomes to consumers.

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 the ACCC is proposing to significantly increase Transend's allowance for capex in the next regulatory period.
- On most benchmark measures of capex, Transend is seen to be significantly higher than other comparable TNSPs, with little apparent justification.
- The excessive WACC applied is underpinned by certain unacceptable variables, including a Market risk premium of 6%, whereas overseas and more recent (and thus more appropriate) evidence would suggest 3.5%; and an equity beta of 1 when the ACCC has itself suggested in other forums that an equity beta of half that value may be appropriate.

- Opex increases amount to almost 100% compared to the current regulatory period and even after adjustment for System Control and Grid Support fees the indication is that Transend has either 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 uniform performance incentives for all transmission entities. Transend's attempts to avoid scrutiny on a number of performance indicators – on spurious grounds – would seem to be evidence to support this position.
- A 1% revenue at risk is grossly insufficient incentive for such an organization to strive for service standards that are acceptable to energy users. A 1% reduction in revenue would only reduce the return to equity by 0.2% to 0.3%.
- A monopoly service provider's attempt to triple its profit before tax over 7 years, whilst at the same time apparently lowering its efficiency, must be seen as unreasonable, totally at odds with the stated objectives of incentive regulation and an attempt to exploit its monopoly power via the regulatory process.

Our overall assessment is that the ACCC needs to substantially modify its final determination in respect of all the above areas if it is to ensure that the interests of Tasmanian energy users are taken into account and the objectives of the regulatory regime it administers are upheld. We could not accept the determination without significant amendment in the above areas.

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 Section 5.3.4.3, Table 5.6 of OTTER's 1999 final report[1], 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 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 (or one-quarter). However, the asset base in Transend's current 2002/03 application was 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? That the ACCC proposes to approve this revised RAB despite the recommendations of its own consultants, GHD, to reduce the RAB (which in our view would still be unreasonably high), is extremely disappointing. The ACCC seeks to justify its decision on the basis that it has no option but to approve the RAB set by the jurisdiction. Customers appreciate the constraints about asset valuation that regulators such as the ACCC have to operate within, but are concerned that the ACCC has given no credence to the pervious OTTER valuation and fails to express strong enough reservations about the excessive asset valuation and its genesis with the shareholder of Transend (hardly reassurance that it is balanced and independent). We find such a meek acquiescence difficult to accept.

We have raised our concerns about the excessive asset valuation and the significant impact it has on the large increase in transmission prices proposed in the draft determination with the Tasmanian Treasury. We have also raised with them the real risk that this could jeopardise one or more of the major users in Tasmania and whether they have assessed this risk and made the Government aware of it. We are convinced that they have not done so and are surprised at the complacency with which this risk seems to be treated by both the Tasmanian Government and the ACCC.

For example, we estimate that the increase in the RAB due to the change in asset values compared to OTTER's approach makes up over 10% of the estimated 43% to 65% increase in average transmission prices over the next regulatory period (over current TUoS price trends). The Tasmanian electricity system (and its economy) is highly reliant on the continued

[1] Investigation into Electricity Supply Industry Pricing Policy, Pricing Determination, OTTER, December 2000

operations of five major users in the State. They all must compete successfully in world markets to remain viable and the continued viability of some, at least, is threatened by this determination.

They are also significant users ('funders') of Transend's network and large increases in transmission charges will have an impact on their operations and the Tasmanian economy. Should it lead to a significant scaling back in their operations, or even closure, Tasmania's remaining users will still have to pay the same revenue to Transend and therefore even higher transmission charges.

For example, if one of these users consumed say 10% of the State's power and was forced to close, then average transmission prices will rise by a further 20% over the current TUoS price trend. That is average transmission prices will increase by almost 62% in 2004 rising to almost 87% above current TUoS price trends. Increases of this magnitude could well risk in a cascading failure rate among Tasmanian businesses and subsequent job losses.

We are extremely disappointed that the Tasmanian Government and the ACCC have not considered such risks and urge the ACCC to bring them to the attention of the Tasmanian Government, along with a request that the assets be revalued downwards to a more realistic level that will not risk such damage to the Tasmanian economy. Alternatively, the ACCC should examine the scope it has to substitute a more reasonable asset valuation for the present one.

3 CAPEX

In 1999, OTTER stated that Transend's forecast of capex between June 2003 and June 2009 was at $167.5M. The ACCC proposes to allow Transend a forecast capex between January 2004 and June 2009 (a six month shorter period) of $307M, an increase of over 80%!

Customers have to question the reasonableness of this level of capex. Transend did not keep pace with its previous capex program, a program of an order of magnitude lower than what the ACCC has approved. 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'.

The ACCC needs to re-examine all these issues. The ACCC also needs to examine the reason why Transend required significantly more replacement Capex relative to its asset base compared to Aurora when their network has a similar age profile. It is inconceivable that Transend's network has deteriorated to a greater extent when both networks operate in similar environments.

4 WEIGHTED AVERAGE COST OF CAPITAL

4.1 Market Risk Premium (MRP)

Transend (and NECG) argues for MRP values higher than 6%, but bows to Australian '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 Tasmanian transmission charges. The ACCC should note that UK regulators have all adopted (around) 3.5% based on forward-looking market views (and judgments). We 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. As established in our earlier submission on the Transend application, Australian customers are paying a higher MRP when there is no evidence that the Australian financial market is less efficient than the UK and US markets.

4.2 Equity Beta

The ACCC has granted Transend an Equity Beta of 1, which implies a risk profile similar to the general market. With 99% of revenues guaranteed by the revenue cap, Transend's market risk is no where near that of the market where significant portions of revenue are constantly at risk. The revenue cap, in fact, implies that an equity beta close to zero may be appropriate given that, should a large customer disconnect, all other customers will have to pay more to cover the shortfall in Transend's revenue.

In any event, the ACCC in other forums have suggested that it is willing to consider equity betas as low as 0.35, as in the current discussions on the draft Statement of Regulatory Principles (SoRP). In addition, the ACCC commissioned Allen Consulting report indicated an Equity Beta of around 0.5 is appropriate. Why has the ACCC repudiated its own research and reverted to the "safe" option to the detriment of Tasmanian electricity customers?

5 OPERATION AND MAINTENANCE EXPENDITURE

In 1999/2000, OTTER approved Transend's O&M expenditure of $17.75M. This increased to $18.34 and $18.32M in 2000/01 and 2001/02, respectively.

We welcome the ACCC's draft decision to reduce the increase in Transend's opex from an average of $35M to $29M per year. However, we also note that this still represents a substantial increase of some $23M, over the regulatory period, from the current opex level (after including the increased costs of the system controller). This leads us to question why Transend is given both increased capex and opex in an operating environment where there is little load growth. Companies in mature competitive market environments can only justify incurring capital investments if such investments reduce their operating and maintenance costs. However, this discipline does not apply to Transend despite the ACCC's claim that it sees its role as to "replicate a competitive market". In fact, the ACCC is proposing to do the exact opposite by allowing substantial increases in both opex and capex.

6 PERFORMANCE STANDARDS

The EUAA and EAG believe that it is important that electricity users in Tasmania obtain a reasonable 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 important in the case of Transend. We welcome the ACCC's finding that Transend's proposed service standard benchmarks are insufficiently challenging and their suggestion of alternative targets.

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 has 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 assist this. 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. We note that the ACCC is permitted significant discretion in the Code that could allow the alignment of regulatory reviews for all TNSPs at the same time.

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

6.1 Performance incentives

However, we believe that the financial incentive of placing just 1% of revenue at risk is totally inadequate. This level of revenue at risk would imply that Transend's return on equity would only be impacted by between 0.2% and 0.3%. This is hardly sufficient to provide Transend with an incentive to improve its performance when higher returns may be achieved with greater ease by other regulatory means.

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 higher transmission charges to "compensate" for the reduced revenue caused by losses from this large customer. In the event that a customer leaves (eg a mine or plant 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 is assured with the transmission

charges rising to compensate for the losses in volumes. This provides very little incentive for Transend to produce a quality service to retain customers and maintain volume.

As noted elsewhere in this submission, the issue of Tasmania's reliance on a small number of large users (who employ substantial numbers of people) and their large share of Tasmania's electricity load makes this point even more important.

This is in contrast to price caps faced by some distribution NSPs (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. The additional risks evident in Tasmania would seem to suggest that a price cap would serve the interests of users and the economy better than a revenue cap.

7 BUSINESS PERFORMANCE

Figure 1 shows the OTTER approved profit before tax (in 2002 $) 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 $35M pa between 2000 and 2002. While Transend met expectations in 2000, it fell below expectations in 2001, achieving a profit before tax of under $22.5M. Transend's profit recovered towards the approved level in 2002, at over $28.5M.

Figure 1 Transend Profit Before Tax

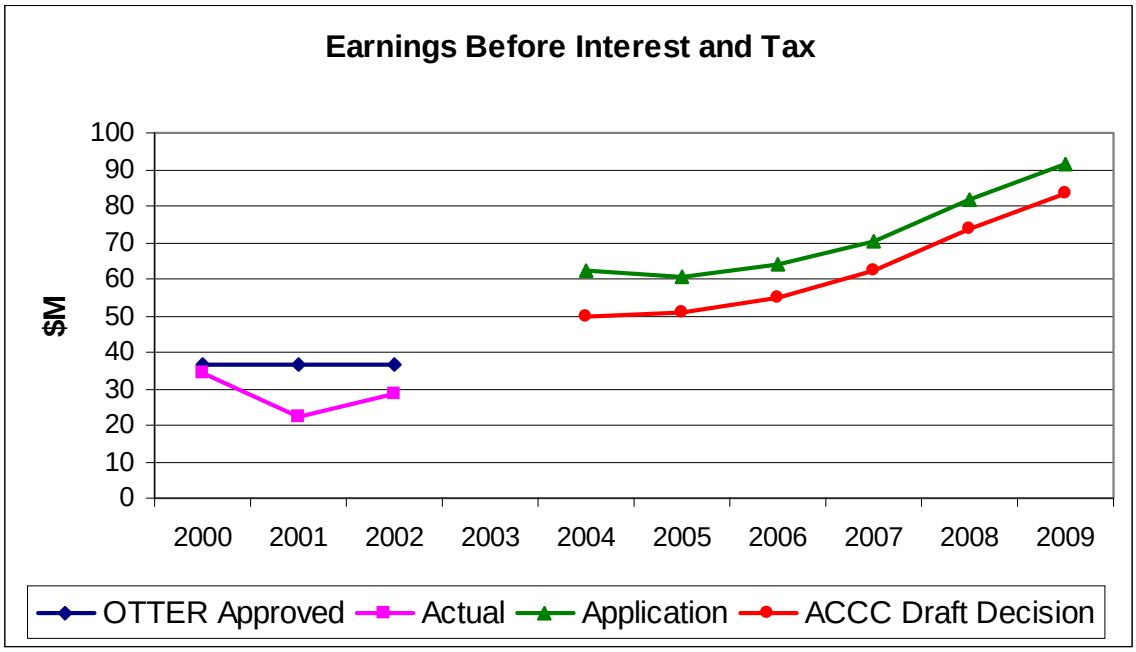


Figure 1 also shows that should its revenue reach the level implied in the ACCC's Draft Determination, its 2004 profit before interest and tax will be 74% higher than its 2002 level. Profit will continue to climb at an average compounded rate of 10.9% pa between 2004 and 2009 so that, by the end of the regulatory period in 2009, its profit will have almost 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.

Significantly, the incentive regulation applied by the ACCC to Transend is meant to deliver increased efficiency to customers. If this was actually the outcome of the ACCC's Draft Determination, we would not be so concerned about this large lift in profits for Transend. However, it is patently obvious from the Draft Determination (and our previous submission) that Transend is highly inefficient and will become more so if this determination is implemented. This is clear from the large increase in opex mentioned above and from benchmarking comparisons of Transend and other TNSPs (see next section).

Hence, not only are Tasmanian customers going to have to pay increased charges for the Transend's inefficiency, but they will also be contributing to an expected large increase in windfall profits for Transend.

This outcome, of an ACCC regulatory determination leading to higher profits coupled with increased inefficiency for Transend, seems to us to be totally at odds with the objective of incentive regulation and is unacceptable to electricity users.

8 TRANSEND'S RELATIVE EFFICIENCY IN THE NEM

Figure 2 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. The Draft Determination would only entrench this situation. This may well indicate that Transend's operational efficiency is deteriorating. This is further reinforced by the subsequent two figures, Figure 3 and Figure 4, which shows that 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. We also do not understand why Transend required significantly more opex relative to its asset base compared to other TNSPs around Australia when their network has a similar age profile to these other NSPs. This is difficult to understand given that Transend's load growth is lower than these other transmission networks.

Figure 2 O & M Cost

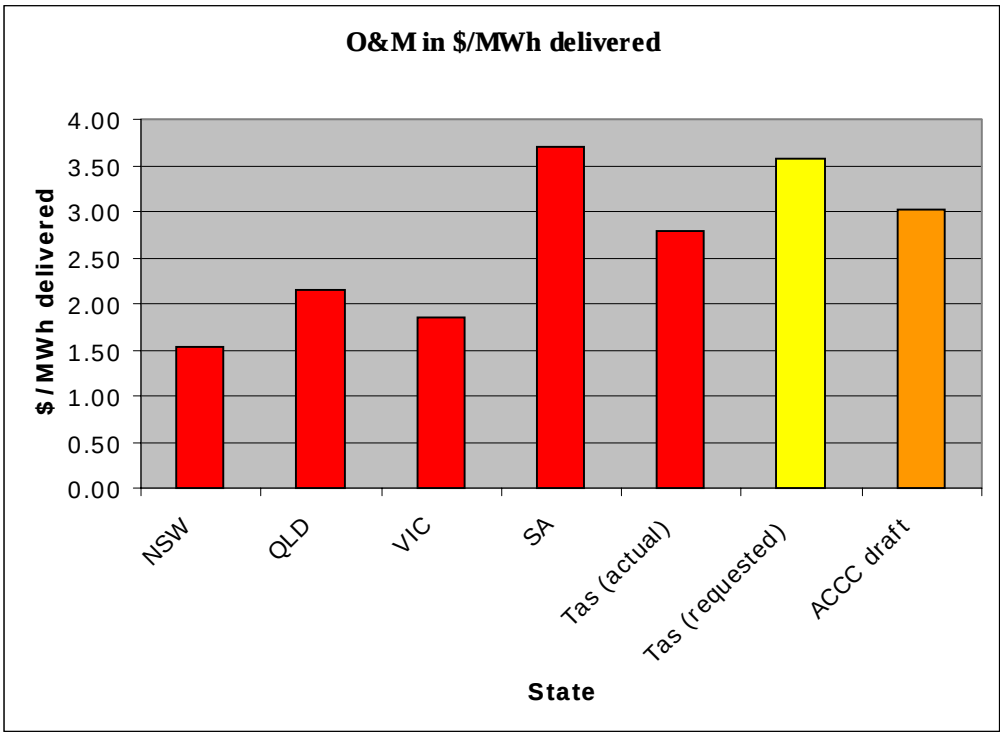


Figure 3 O & M as a proportion of Asset Base

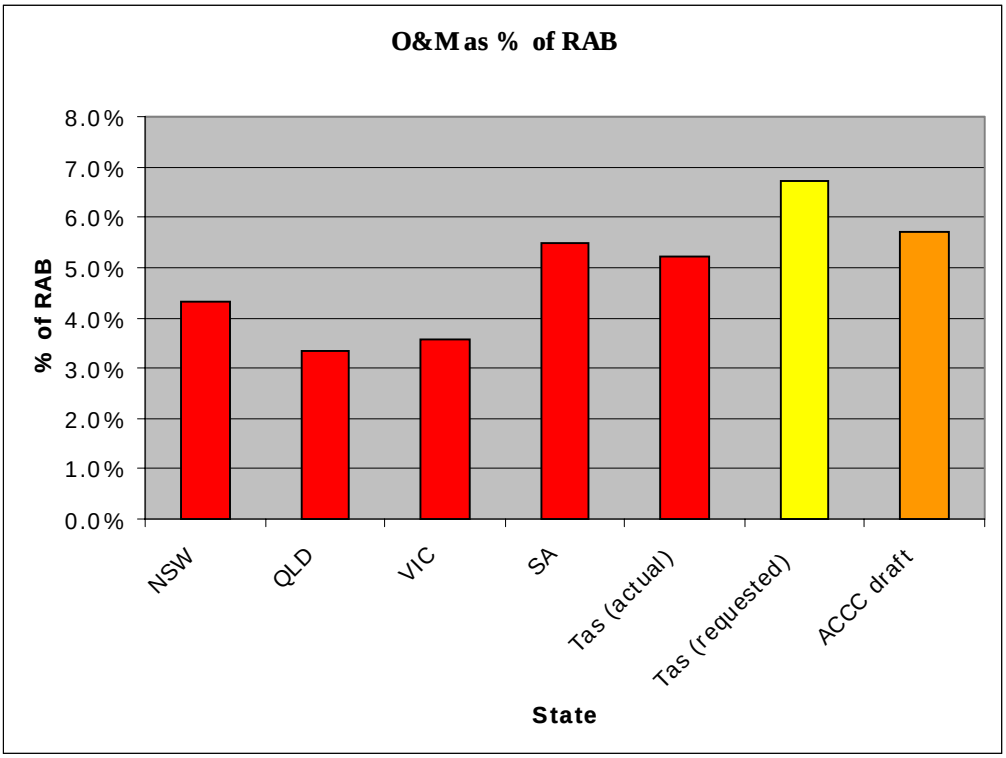
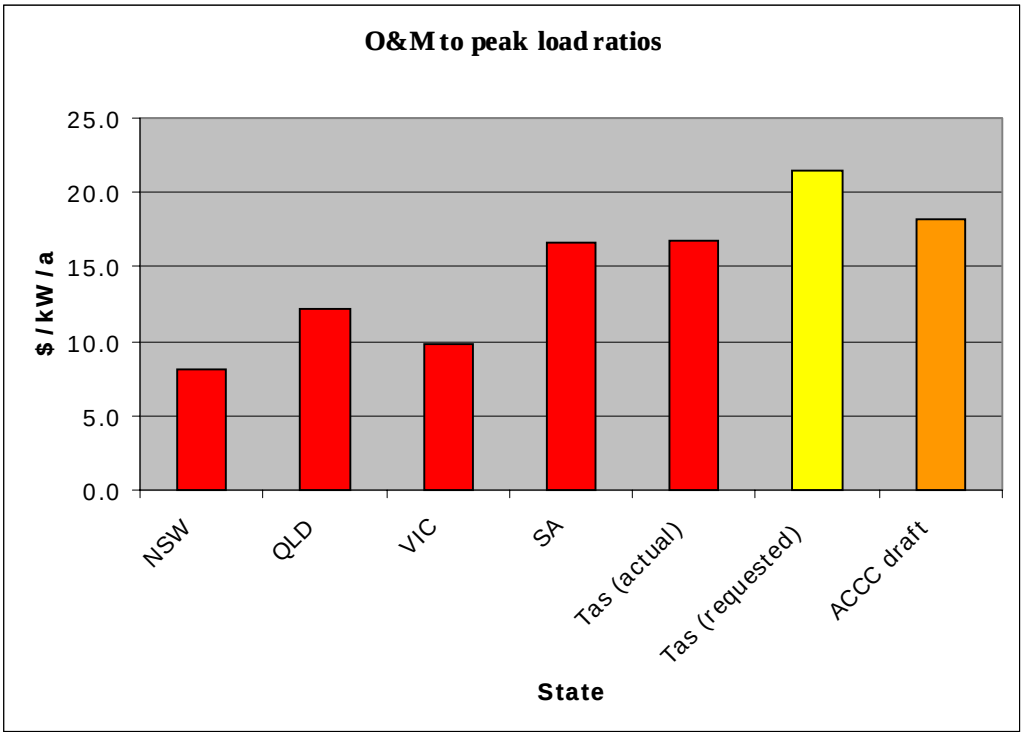
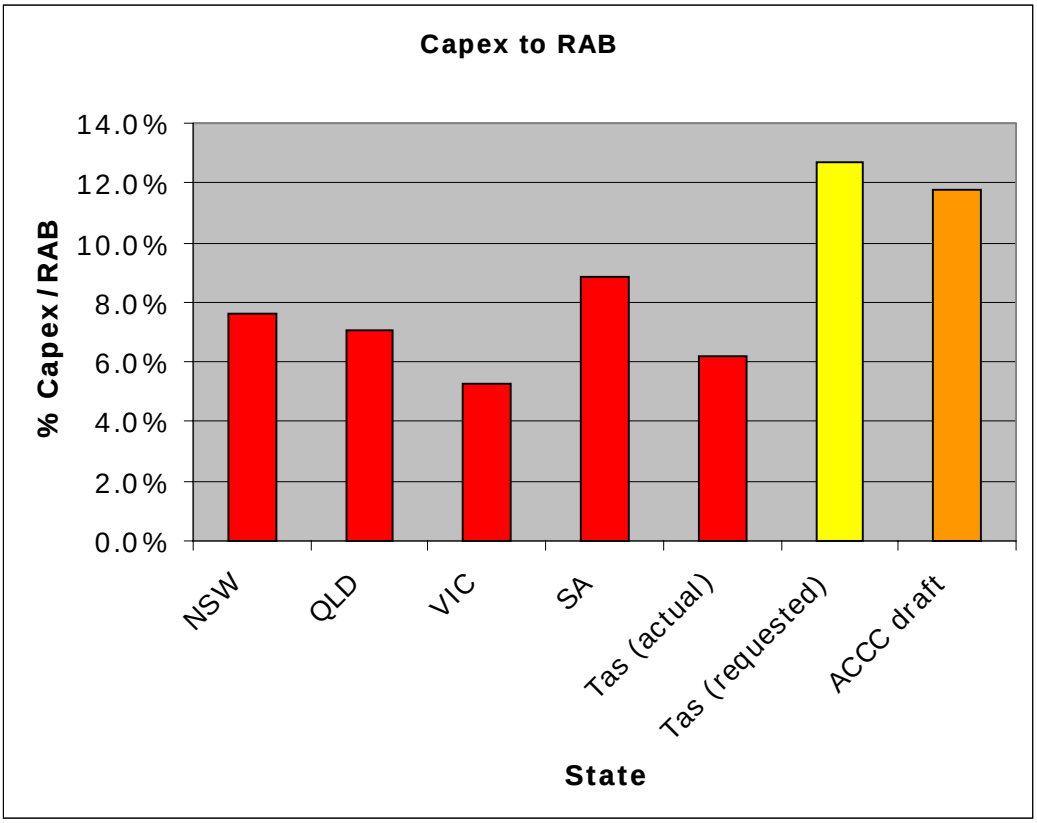


Figure 4 O & M to Peak Load



With its current actual capex spend, Transend is not misaligned compared with most other Australian states, exceeding only PowerNet[2] as a proportion of its asset base. However, as seen in Figure 5, with its application, as well as the ACCC's Draft Determination, 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. It is difficult to believe that, given the similar asset age profiles of these TNSPs, Transend's network has deteriorated to a greater extent than the other TNSP meaning that Transend would required such a large capital injection into their system.

Figure 5 Capex as a proportion of Asset Base



[2] In this regard, we note that Victoria's capex spend may be under-reported as major new items may not have been captured in PowerNet's reporting as in Victoria, new capex is undertaken by VENCorp. PowerNet only undertakes replacement capex.

9 SUMMARY AND CONCLUSIONS

We wish to remind the ACCC that regulated entities are unique. They face minimal risk of non-payment and have a far lower risk profile than almost all listed companies in a competitive market. The prices of their products are indexed against inflation. They have an asset base established by the use of the Depreciated Optimised Replacement Cost (DORC), which is well known to favour owners and disadvantage users, unlike all other companies who use a Depreciated Actual Cost (DAC).

To enjoy these advantages, regulated entities are required to submit to a regulatory authority. However, they enjoy an information advantage over others (including the regulator) and have a relatively high degree of freedom of action once a determination is made. The only opportunity and avenue that customers have to put their views across – and hopefully have it taken into account in determining the cost of service – is during such a determination. Generous determinations by the regulatory authority fail to deliver competitive outcomes to consumers, who will have to pay for such generosity.

Specifically, the ACCC Draft Determination for Transend has failed customers because:

- The Regulatory Asset Base has been unreasonably and significantly revalued upwards by the Tasmanian Government (and more-or-less accepted by the ACCC) from the level accepted by its current regulator, OTTER.
- Capex has been underspent in the current regulatory period, yet the Draft Determination proposes to significantly increase capex in the next regulatory period and Transend attempts to seek even greater allowance for capex.
- The 6% market risk premium given to Transend is above that set by other internationally comparable regulators and an equity beta of 1 does not reflect the very low risk faced by TNSPs. The impact of this high MRP and equity beta amounts to and extra $15M to $21M pa in revenue to Transend over the next regulatory period.
- 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”.
- A 1% revenue at risk is surely insufficient incentive for such an organisation. A 1% reduction in revenue does not make a significant impact on such a high level of return on equity.
- A monopoly service provider operating under incentive regulation as practiced by the ACCC should not be allowed to triple its profit before tax over 7 years, whilst at the same time seemingly becoming even more inefficient than it already is, with customers left to pay for both the monopoly rents and inefficiency.

We are most concerned that the ACCC’s Draft Determination will, if implemented, result in a 60% increase in transmission charges over the next five years and that an increase of this magnitude will have a seriously detrimental impact on electricity users in Tasmania, on the Tasmanian economy (which is reliant on a small number of large users of energy), on the potential for Tasmania to attract new industries that rely on energy and on jobs (both current and newly created). Our analysis in this submission shows the potential extent of this impact

may extend beyond this immediate price increase should one or more major businesses fail, which could result in a vicious cycle of TUoS price rises and business failures (involving job losses).