EUAA Submission to the AER on Transend's 2009 to 2013 Revenue Proposal

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Executive Summary

We welcome the opportunity to provide a submisison as part of the AER's regulatory review of Transend for the period 2009 to 2014. The EUAA has over 100 members, including most of Tasmania's largest energy users and therefore has a significant interest in this review. We support an effective, open and transparent regulatory process that will properly scrutinise Transend's proposal and ensure that our members' interests are fully considered and responded to effectively.

Energy users are facing significant cost pressures on multiple fronts and we are very concerned that Transend is proposing a 72% increase in average TUoS between 2008 and 2014. This comes on top of a 60 per cent increase in the last regulatory period.

This is a massive increase and probably has the unfortunate distinction of rivalling the highest level of price increases for any business in Australia over the same period. It would not reflect well on the regulatory process and continues a trend seen by some transmission network service providers of expenditure increases at a significantly higher rate than the rate of growth of energy or demand. Unfortunately, Tasmanian energy users will have no choice but to pay the increases if they wish to remain in business in Tasmania, as Transend is a monopoly service provider.

Cost increases of this magnitude will impact the competitiveness of Tasmanian energy users and affect their operations at a time when their energy costs are already under pressure – electricity prices are rising, there are gas cost pressures, a carbon price is coming, there is to be an expanded renewable energy target and Aurora's distribution charges have also increased.

Transend has applied for total expenditure over the period from 2009 to 2014 of $961m (in 2008$). This is an increase of 71% (in constant 2008$) on the total expenditure that was allowed by the ACCC in its 2004 to 2009 revenue decision.

Energy users are bearing the burden of the rapidly declining productivity of this industry. It is therefore vital that the AER carefully scrutinise the Transend proposal to ensure it is sound, robust and transparent.

The rest of this executive summary set outs our main comments on Transend's opex and capex proposal and summarises our main suggestions for action by the AER:

Transend's opex application

Transend's opex application shows a continuation of the significant increases in operating expenditure experienced over its history, albeit that the rate of increase is slower than the actual expenditure over the current regulatory period.

Transend has suggested that the AER should use the actual level of operating expenditure in 2007 as the starting point for the calculation of the operating expenditure allowance for the next regulatory period. The basis of their argument for this is that Transend has financial incentives to spend efficiently, and so the "revealed" level of expenditure should be assumed to be efficient. The EUAA rejects this argument for the following reasons:

- There is no evidence to suggest that Transend has strong incentives to reduce costs in order to increase profits. It follows that there is no basis to assume that the observed level of expenditure is an efficient level of expenditure;
- The level of operating expenditure in 2007 was considerably higher than the level in 2006 on the basis of one-off events. Specifically, the 2006/7 Financial Accounts identify one-off charges of $8.5m for defined benefit superannuation contributions and asset write-downs. Such one-off costs should be excluded in projections of future opex costs;

In addition, the EUAA reject's Transend's argument that operating costs should continue to rise over the period of the control as they suggest.

The EUAA's conclusion is that a large part of the significant decline in Transend's operating cost productivity is explained by the cost of increased managerialism and bureaucracy. We suggest that Transend is more focussed on insulating itself from risks, rather than seeking cost effective ways to

manage those risks. This is disappointing considering the history of innovation and creative problem-solving that has characterised the provision of transmission services in Tasmania in the past.

The EUAA considers that it would be inappropriate to make any allowance for either debt or equity raising costs, for the following reasons:

- Transend has simplified debt management arrangements. All borrowings and investments are executed with Tascorp with the exception of minor unsecured overdraft and credit card facilities. Furthermore such costs will already be included in Transend's reported operating expenditure and hence any additional provision would be double counting.
- Transend has issued just 4 shares to the Minister for Energy and Treasurer and incurs no equity raising costs. It is not consistent with the AER's "reasonableness" obligations under the Rules to compel energy users to compensate Transend for expenditure it will not incur.

Transend's capex application

Transend has applied for capital expenditure averaging $136m per annum in 2008$ over the period 2009 to 2014. This is 68% higher than the average amount it was granted by the ACCC for the 2004 to 2009 period and 150% higher than the amount granted by OTTER for the period 1999 to 2002 (constant 2008$).

The EUAA is concerned about Transend's ability to forecast and control its capital expenditure. For example:

- In 1999 it predicted it would need to spend $448m over the following ten years. In the event it has spent almost twice as much.
- In 2003, Transend applied to the AER for expenditure equivalent to $330m over the period 2004 to 2009. In the event it spent $396m (in 2003$).

The Waddamana to Lindisfarn project, Transend's flagship augmentation project, is of particular concern. The cost of this project has blown out considerably over time:

- In August 2004, Transend said that this project would cost $46.7m
- Three years later in August 2007, it said it would cost $130m.
- Just nine months later in May 2008, Transend said that this had risen to $177m.

If costs have blown out so significantly on this 'flagship project' what about lesser projects that have not been subject to such detailed examination?

In view of such significant cost blow-outs, it may be better for network support agreements to continue in order to defer, or further avoid such significant expenditure. The EUAA requests that the AER examine this issue in detail.

Other concerns that we have with Transend's capex proposal are as follows:

- Transend has not produced analysis to assess the benefits and detriments of deferring expenditure to avoid the large increase in its expenditure at the top of the economic cycle;
- We are also concerned that the size of this program is such that Transend's ability to execute it efficiently becomes a cause for concern.
- Transend described their capital governance arrangements to us, to expand upon the explanation in the submission. We found the explanation unconvincing. We are also concerned that Transend's Board does not have access to resources and independent advice in scrutinising management's claims. The AER should investigate this thoroughly.

The 2009 to 2014 expenditure claim is excessive. Transend's financial accounts report assumptions of asset lives of between 40 and 80 years in its depreciation calculations. While we have not done a precise calculation, we would expect that the weighted average asset life of Transend's assets would be around 45 years, which would imply ongoing replacement expenditure 2.2% of the asset base. The asset base at 1 January 2009 will be around $1bn, implying ongoing expenditure to replace assets of $22m per year – one-

tenth of what Transend has sought. Transend needs to explain the reason for this inflated level of expenditure relative to asset lives. They claimed at the Public Forum that "ten per cent was reasonable" but this seems to be questionable.

Suggestions for action by the AER

A summary of our specific suggestions for action by the AER is as follows:

- The AER should reject the choice of 2007 as the starting year for the opex calculation. Instead, the AER should determine a bottom-up assessment of reasonable opex for each year in the revenue control period. The level of expenditure increase that Transend has proposed is not sustainable.
- The AER should reject Transend's claim for debt and equity raising costs.
- The AER should carefully scrutinise Transend's claim that capital expenditure in the existing control period was prudently incurred. This is especially important since TransGrid has exceeded its allowance.
- The AER should carefully examine the Waddamana to Lindisfarne project and the reasons for the ongoing and very significant increase in the cost of this project. Implications of this for the reasonableness of the rest of Transend's augmentation claim should be drawn.
- The AER should reject Transend's replacement expenditure claim. It is very much higher than is consistent with the depreciation charge for ageing assets.
- The EUAA recommends that the AER, with participation from all TNSPs and DNSPs under its regulatory control, and end users, establish an independent benchmarking project overseen by a committee of network businesses and end users. This is also a feature of our recent submissions responding to the Transgrid and New South Wales distribution regulatory reviews by the AER.

1 Introduction and Our Interest in this Review

This document is the EUAA's submission to the AER on Transend's revenue application for the period 2009 to 2014. We welcome the opportunity to provide it as part of the AER's process. We support an effective, open and transparent regulatory process that will properly scrutinise Transend's proposal.

The EUAA is a non-profit organisation funded by membership fees, internally generated revenue and external funds. It is focused entirely on energy issues and was formed in 1996. Members determine EUAA policy and direction and elect a Board made up of fellow members. The Association members are business users of energy with activities across all states and many sectors of the economy. The EUAA also allows energy companies and others with an interest in energy matters that affect end users, to join.

The EUAA has over 100 members, including members with significant interests in Tasmania. This includes the State's largest energy users, some of whom are directly connected to the Transend system. All EUAA Tasmanian members will be affected by the outcome of this review.

Whilst the EUAA welcomes Transend's proposal and appreciates the considerable effort that has gone into preparing it, we are generally disappointed in Transend's application. It continues a trend seen by some transmission network service providers of expenditure increases at a significantly higher rate than the rate of growth of energy or demand. Energy users are bearing the burden of the rapidly declining productivity of this industry.

End-users are presently facing multifaceted and significant cost pressures on many fronts and we are therefore very concerned that Transend is proposing a 72% increase in average TUoS between 2009 and 2014. Cost increases of this magnitude will impact the competitiveness of Tasmanian energy users and affect their operations at a time when their energy costs are already under pressure – electricity prices are rising, there are gas cost pressures, a carbon price is coming, there is to be an expanded renewable energy target and Aurora's distribution charges have also increased significantly. Transend needs to substantiate its proposals with robust cost-benefit data, and demonstrate how the proposal will benefit users, how capex is appropriately timed in terms of the economic cycle (would deferral reduce costs?) and how it has sought to minimise its cost escalators.

The submission is set out as follows:

- The next section provides an introduction to Transend and the EUAA's overview of Transend's revenue application. This establishes some aspects of the context to the revenue application that we think the AER should be aware of.
- Section Three analyses Transend's efficiency incentives and draws implications of this for their operating expenditure proposal.
- Section Four provides specific comments on Transend's capex program.

Notwithstanding the EUAA's strong disagreement with the significant expenditure increase that Transend has proposed for the 2009 to 2014 period, we commend Transend for the comprehensive and well-constructed application that it has submitted.

2 Background Comments

Transend was created as a proprietary limited company in 1998 when the Hydro Electric Commission was split into Hydro Tasmania, Aurora and Transend.

Transend is a State Owned Company, whose two shareholders ("members") are the Minister for Energy and the Tasmanian Treasurer. It has between three and eight Directors all of whom are appointed by the members. The Board of Directors appoints the CEO and ratifies the CEO's choice of Chief Financial Officer and Secretary. Transend's financing is arranged and provided by Tascorp.

Transend is currently entering its third revenue control period. The first revenue control from 1999 to 2002 was set by the Office of the Tasmanian Energy Regulator. This first revenue control was extended for a year, after which the first revenue control decision established by the Australian Competition and Consumer Commission (ACCC) from 1 January 2004 to 30 June 2009.

The Tasmanian Government has revalued Transend's assets twice. The first time was in 2001 preceding the ACCC's first revenue control decision. This increased the valuation of Transend's assets from $433m million to $521m million, or by 20% per cent.

The second revaluation – which will not affect the valuation of the regulated assets (and hence prices) but is reflected in the statutory accounts – took place in 2007. This revaluation preceded the Tasmanian Government's decision to place debt on Transend's balance sheet, and then transfer funds from Transend to Hydro Tasmania in October 2007.

Since its creation in 1998, Transend has grown its expenditure and staff numbers rapidly. In particular, the following is noted:

- In 1999, Transend had 50 employees[1]. By 2007 this had risen about 4.5 times to 224.[2]
- From 1999 to 2008 Transend grew its operating expenditure in constant 2008$ by 55% which equates to Compound Annual Growth Rate (CAGR) of 6.2% p.a.[3]
- Transend's average capital expenditure (in constant 2008$) in the period 1999 to 2003 was $54m per year. For the period 2004 to 2009, Transend project that this will rise by 68% to $91m per year.[4]

Over the period 1999 to 2007, electricity consumption in Tasmania grew by 0.6% per annum[5]. Since expenditure has risen more quickly than electricity consumption, Transend's operating cost productivity has declined significantly by 5.6% per year in real terms over this period. Similarly, asset intensity (the value of assets needed to provide the transmission service) has risen significantly as a result of asset revaluation by the Tasmanian government in 2001 and significant ongoing increases in capital expenditure since 1999.

By way of context, we note that the transmission network in Tasmania has generally had less redundancy than transmission networks in mainland states of Australia. This is a result of the geographically dispersed hydro generation sources in Tasmania, the high cost of building and maintaining transmission over long distances and over rugged terrain, and the relatively small volume of electricity transported in a state with a maximum demand below 2,000 MW and annual energy consumption of around 10 TWh. To ensure

[1] Investigation into Electricity Supply Industry Pricing Policies, November 1999, Final Report, Office of the Tasmanian Energy Regulator.
[2] Transend 2006/7 Annual Report
[3] This calculation is based on data from the following sources: Chapter 4 of "Investigation into Electricity Pricing – Final Report", produced by the Office of the Tasmanian Energy Regulator, CPI – All Australia, Transend Transmission Revenue Proposal for the Regulatory Period 1 July 2009 to 30 June 2014.
[4] See sources referred to in footnote 3.
[5] Data on 2007 electricity consumption is from NEMMCo quoted in the AER's 2007 State of the Market Report. Data on 1999 electricity consumption is from "Output Group 4" published by the Department of Infrastructure, Energy and Resources, Government of Tasmania, available at http://www.dier.tas.gov.au/annual_reports/2001_annual_report/output_group_4

reliable supplies, transmission provision in Tasmania has a history of innovation and clever engineering, particularly in the fields of telemetry, SCADA and remote operation, matched by commercial arrangements with generators and key energy users needed to manage risks efficiently.

Transend has a track record of spending above its regulatory allowance. This has been the outcome based on regulatory decisions set by both OTTER (for Transend's first regulatory control period) and the ACCC (for Transend's second control period). In the case of its capital overspend in its first regulatory control period, the full value of this overspend was recognised in the regulatory asset base. Similarly, Transend claims that the capital overspend in the current regulatory period is justified and hence the full value of the expenditure should be included in the regulated asset base and hence included in the calculation of regulated prices. We suggest that the AER should carefully scrutinise this expenditure and disallow the recovery of expenditure that was not prudently incurred.

3 Summary Comments on Transend's 2009 to 2014 Revenue Application

Transend has applied for total expenditure over the period from 2009 to 2014 of $961m (in 2008$). This is an increase of 71% (in constant 2008$) on the total expenditure that was allowed by the ACCC in its 2004 to 2009 revenue decision.

Transend's opex application shows a continuation of the significant increases in operating expenditure experienced over its history, albeit that the rate of increase is slower than the actual expenditure over the current regulatory period.

Transend has applied for capital expenditure averaging $136m per annum in 2008$ over the period 2009 to 2014. This is 68% higher than the average amount it was granted by the ACCC for the 2004 to 2009 period and 150% higher than the amount Transend was granted by OTTER for the period 1999 to 2002 (all calculations in constant 2008$).

3.1 Impact on transmission prices

The effect of Transend's expenditure application will be to increase average transmission prices by 72% (in constant currency) between 2009 and 2014[6]. If Transend's application is granted, the effect will be to increase average transmission prices by 141% (in constant currency) for the ten years between 2003 and 2013, a CAGR of 9.2%.

This is a massive increase and probably has the unfortunate distinction of rivalling the highest level of increases for any business in Australia over the same period. Unfortunately, Tasmanian energy users will have no choice but to pay the increases if they wish to remain in business in Tasmania, as Transend is a monopoly service provider. It is therefore vital that the AER carefully scrutinise the Transend proposal to ensure it is sound, robust and transparent.

[6] This assumes a continuation of the trend rate of growth of electricity consumption of 0.6% per annum, rather than Transend's assumption of 1.9% p.a.

4 Comment on Transend's Expenditure Proposal

This section discusses key aspects of the Transend expenditure proposals for the next regulatory period.

4.1 Transend's opex proposal

There is strong evidence to suggest that Transend does not seek to reduce costs to raise profits. This can be seen in the following:

- Transend's mission statement "(to) *efficiently provide a reliable and secure electricity transmission service at a cost commensurate with appropriate and sustainable returns to shareholders*" which suggests that profitability is a subsidiary objective;
- We found no evidence to suggest that the CEO or other key executives' compensation is related to Transend's profitability.
- We found no publicly available information of any report of the Board to its members on Transend's profitability. The Board did, however, report specifically on Transend's ability to repay its debts;
- The Tasmania Government revalued Transend's assets in 2006/7. The effect of this was to degrade the return on assets in 2007 to around 2%. Such action is consistent with the low value placed by Transend's Directors and shareholders on Transend's profitability.

Transend has suggested that the AER should use the actual level of operating expenditure in 2007 as the starting point for the calculation of the operating expenditure allowance for the next regulatory period. The basis of their argument for this is that Transend has financial incentives to spend efficiently, and so the "revealed" level of expenditure should be assumed to be efficient. The EUAA rejects this argument for the following reasons:

- As discussed above, there is no evidence to suggest that Transend has strong incentives to reduce costs in order to increase profits. It follows that there is no basis to assume that the observed level of expenditure is an efficient level of expenditure;
- The level of operating expenditure in 2007 was considerably higher than the level in 2006 on the basis of one-off events. Specifically, the 2006/7 Financial Accounts identify one-off charges of \$8.5m[7] for defined benefit superannuation contributions and asset write-downs to explain the significant increase in the level of operating expenditure in 2007 compared to 2006. Such one-off costs should be excluded in projections of future opex costs;

As discussed earlier, Transend's opex proposal continues a trend established since its creation, of rapidly rising expenditure.

We have considered whether there is a basis for Transend's opex to have increased over time. We identified the following as factors that may justify increased expenditure:

- A proactive approach to risk management which results in higher visible costs, although benefits that are less visible and often impossible to value;
- The need to operate effectively in an increasingly complex environment;
- Labour costs that rise in real terms.

But other businesses face these same cost pressures. They are managed through the development of new tools and more effective ways of working, so that over time Australia's economy has been able to sustain rising productivity. The EUAA can see no good reason why transmission network services businesses should be exempt from the requirement to raise their productivity at a trend rate that is at least equal to that of the rest of the economy. In fact, this was one of the original objectives of the use of

[7] See page 6 of Review of Operations in Transend 2006/7 Annual Report

incentive regulation for energy network monopolies and why end users supported its use. However, over time, sight seems to have been lost of this and the costs of network monopolies, like Transend, have increased significantly without any offsetting productivity benefits.

Additional factors that would suggest there is little basis for the substantial increase in Transend's operating expenditure include:

- Economies of scale and economies of scope which should result in decreasing costs per unit of electricity distributed;
- The absence of structural changes in the Tasmanian economy that might justify higher operating expenditure. For example, Tasmania is not as exposed to the resources boom or rapid population migration seen in some other parts of Australia. On the contrary, the trend rate of electricity consumption growth in Tasmania is the lowest in Australia, Tasmania now has access to natural gas which is to some extent displacing electrical consumption in industry and residential applications, and has steady industrial activity.
- There is no evidence of reliability or delivery failures in the provision of transmission services that could justify greater operational expenditure.

The EUAA's conclusion is that a large part of the significant decline in Transend's operating cost productivity is explained by the cost of increased managerialism and bureaucracy. For example, we note that in supporting its regulatory submission, Transend commissioned consultancy reports from Nous, Sinclair Knight Merz, Roam Consulting, Competition Economists Group, Brothers and Newton, PB Associates, Marsh and Evans & Peck. This is despite Transend's increase in its own staffing levels from 50 to 245 over the last 8 years. This may suggest that Transend is more focussed on insulating itself from risks, rather than seeking cost effective ways to manage those risks. This is disappointing considering the history of innovation and creative problem-solving that has characterised the provision of transmission services in Tasmania in the past.

4.1.1 Debt and equity raising costs

Transend has sought expenditure of $17.4m for the cost of raising debt and equity. This compares to their 2004 to 2009 application of $5.5m for the same cost[8]. The EUAA considers that it would be inappropriate to make any allowance for either debt or equity raising costs, for the following reasons:

- Transend has simplified debt management arrangements. For example, the 1996/7 financial accounts show that all borrowings and investments are executed with Tascorp with the exception of minor unsecured overdraft and credit card facilities. Furthermore any costs related to its debt management activities with Tascorp will already be included in Transend's reported operating expenditure and hence any additional provision for such expenditure would be double counting.
- Transend has issued just 4 shares to the Minister for Energy and Treasurer, which are held in trust for the Crown in the Right of Tasmania. Transend incurs no equity raising costs. It has no need to incur under-writing fees, brokerage charges, the publication of product disclosure statements or similar costs related to raising equity. All costs related to financial reporting to shareholders are already included in the calculation of operating expenditure. It is not consistent with the AER's "reasonableness" obligations under the Rules to compel energy users to compensate Transend for expenditure it will not incur.

4.1.2 Benchmarking

To Transend's credit they provided some benchmarking information based on an ITOMS study and also through some specific measures developed by PB Associates in a study they commissioned.

[8] See pages 33 and 72 of ACCC Decision 2004.

The ITOMs information is interesting, but to be able to interpret it, it is necessary to know how the benchmarks have been defined, what data was provided and who the comparative businesses were. Without this information, there is a risk that this information could be misinterpreted.

We also commend the analysis undertaken by PB Associates for Transend. As always the challenge with such benchmarking exercises is data availability, data definition and normalisation for business structure and exogenous variables.

PB has benchmarked the expenditure associated with various activities within Transend's, against what it believes to be the expenditure of such activities in other electricity transmission and distribution businesses. The benchmarked activities were "corporate affairs, corporate shared, human resources, IT, finance and asset management". Unfortunately businesses define these activities differently and apportion their costs amongst these activities differently. For this reason, we suggest that before the AER relies on these benchmarks to make decisions, it should dig into the comparative assessment to ensure that definitional and normalisation challenges have been effectively dealt with.

The EUAA also observes that firm or industry commissioned benchmarking can be subject to actual or perceived biases and it would therefore prefer that independent benchmarking become a feature of the regulatory regime applied by the AER. Such a process could be overseen by the AER with participation by all TNSPs and DNSPs, as well as energy users. The EUAA would welcome such a process being set up and would welcome participation in it. Such a process could provide useful information over the course of the next regulatory period that would be a valuable addition to more effective regulation in the next regulatory period. However, if TNSPs are not willing to contribute, publicly available information could be used.

The EUAA therefore recommends that the AER, with participation from all TNSPs and DNSPs under its regulatory control, and end users, establish an independent benchmarking project overseen by a committee of network businesses and end users.

4.2 Transend's capex proposal

The EUAA is concerned about Transend's ability to forecast and control its capital expenditure. For example:

- In 1999 it predicted it would need to spend $448m over the following ten years.[9] In the event it has spent almost twice as much.
- In 2003, Transend applied to the AER for expenditure equivalent to $330m[10] over the period 2004 to 2009. In the event it spent $396m (in 2003$).

The Waddamana to Lindisfarn project, Transend's flagship augmentation project, is of particular concern. The cost of this project has blown out considerably over time:

- In August 2004, Transend said that this project would cost $46.7m[11].
- Three years later in August 2007, it said it would cost $130m[12].
- Just nine months later than this in May 2008, Transend said that this had risen even further to $177m[13].

[9] See "Transend Issues Paper, April 1999, quoted on page 116 of "Investigation into Electricity Pricing – Final Report", Office of the Tasmanian Energy Regulator. .
[10] See page 12 of ACCC Decision.
[11] See page 44 of "Southern Power System Security, Proposed New Large Network Asset, Final Report.
[12] See page 26 of "Waddamana to Lindisfarne 220 kV application to establish a new large transmission network asset, Final Report, August 2007.
[13] See page 87 and page 94 of "Transend Transmission Revenue Proposal for the Regulatory Control Period 1 July 2009 to 30 June 2014. Page 87 says that $153m is still to be spent on this project, while page 94 says that $24m has already been spent on this project.

The EUAA's general concern is that if costs have blown out so significantly on this flagship project what could be said of several lesser projects that have not been subject to such detailed examination? In view of such significant cost blow-outs, it may be better for network support agreements to continue in order to defer, or permanently avoid such significant expenditure. The EUAA requests that the AER examine this issue in detail.

Other concerns that we have with Transend's capex proposal are as follows:

- It is disappointing that Transend has not produced analysis to assess the benefits and detriments of deferring some expenditure to avoid maximising its expenditure at the top of the price cycle;
- We are also concerned that the size of this program is such that Transend's ability to execute it efficiently becomes a cause for concern.
- Transend described their capital governance arrangements to us, to expand upon the explanation in the submission. We found the explanation unconvincing. We are also concerned that Transend's Board does not have access to resources and independent advice in scrutinising management's claims.

4.2.1 Asset renewal expenditure

Transend has requested expenditure of $226m[14] on asset renewal over the period 2009 to 2014 excluding expenditure on physical security/compliance, inventory/spares and operational support systems. This compares to their renewal expenditure claim of $186m[15] for the 2004 to 2009 period.

The 2009 to 2013 expenditure claim is excessive. Transend's financial accounts report assumptions of asset lives of between 40 and 80 years in its depreciation calculations[16]. While we have not done a precise calculation, we would expected that the weighted average asset life of Transend's assets would be around 45 years, which would imply ongoing replacement expenditure of 1/45 = 2.2% of the asset base. The asset base at 1 Jan 2009 will be around $1bn, implying ongoing expenditure to replace assets of $22m per year – one-tenth of what Transend has sought. Transend needs to explain the reason for this inflated level of expenditure relative to asset lives. They claimed at the Public Forum that ten per cent was "reasonable" but this seems to be questionable.

Furthermore, we note the two significant asset revaluations by the Tasmanian Government in 2001 and by Transend in 2007. Such revaluations by the Tasmanian Government and Transend, appear to contradict Transend's argument that its asset base is rapidly ageing and that there is need for replacement expenditure well above the rate commensurate with the depreciation of its assets.

[14] See page 85 of Revenue Proposal.
[15] See page 32 of ACCC Decision, Tasmanian Revenue Cap 2004 to 2008/9
[16] Other than for short lived IT or business support capex which only forms a small part of Transend's asset base. See page 35 of Financial Report in Transend's 2006/7 annual report.

5 Weighted Average Cost of Capital

The EUAA recognises that in order to maintain stability in service standards and minimum prices in the long run, the return provided to a TNSP should provide for an efficient level of investment over time, ensuring a correct balance between capital maintenance and renewal in a broader context that encourages non-network solutions to support growth and service quality bearing in mind the low risk position of TNSPs.

Chapter 6A of the National Electricity Rules, v21, prescribes the method and values for most of the parameters to be used in calculating the Weighted Average Cost of Capital (WACC) and taxation in a TNSP's revenue proposal. The setting of these parameters are the result of a consultative and iterative process that now provides TNSPs with a degree of certainty affecting the method for setting regulated revenue, therefore reducing investment risk, and the effect this has on the timing and scope of investment decisions, and ultimately end-user prices.

Two of the major parameters in the WACC that are determined as part of a TNSP's revenue determination are the nominal risk free rate and the debt risk premium. Given that all other parameters are fixed, the EUAA will not discuss them as part of these comments.

We note, however, that these parameters are currently being reviewed by the AER in a separate process but that the AER has not sought to have the parameters emerging from this review apply to the Transend reset even though the timing of both reviews is closely aligned and failure to apply new WACC parameters to Transend will make the parameters applied out-of-date. We do not support the AER's position on this. We believe there is strong evidence at least two of the existing parameters are badly out-of date and inflate the regulated rate of return provided to transmission and distribution businesses. Unfortunately, the AER's position is likely to force end users to pay even higher transmission charges to Transend for another five years. Given the concerns we expressed earlier in this submission about the formidable and multifaceted costs pressures facing energy users in the next five years this is a most unfortunate decision for the AER to have taken.

The EUAA has also submitted a Rule Change Proposal to the AEMC seeking to have two of the key WACC parameters at issue, the *equity beta* and *gamma*, whose values are embedded in the National Electricity Rules, changed to values that better reflect their true value. If this is accepted, it will result in a significant downward adjustment in the WACC and in network charges. The Rule Change Proposal is supported by evidence and argument compiled by an acknowledged expert in this field, Associate Professor Martin Lally of the Wellington University. Our proposal also seeks a Rule Change that would see the new parameters for the equity beta and gamma applied to all regulatory reviews that commenced after the proposal was submitted, including this one.

5.1 Risk Free Rate and the Debt Risk Premium

The National Electricity Rules prescribe the method for determining the nominal risk free rate. This method provides the AER with discretion in determining the period of time from which, on a moving average basis, the risk free rate is calculated using 10 year government bonds. The Debt Risk Premium is then determined by calculating the premium between the annualised nominal risk free rate and the observed annualised benchmark corporate bond rate which meet the prescribed credit rating and maturity requirements.

The EUAA notes recent market volatility, and recommends that the AER is careful that the effects of the current credit crisis and global slow-down are appropriately weighted in the selected period. The EUAA notes that expectations are suggesting a shift in monetary policy, with anticipated reductions in the cash rate leading to a downward shift in yield curves. Significant falls in commodity prices over the past 3-6 months also appear to be easing inflationary expectations, potentially underlying the changed outlook for monetary policy.