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Dear Mike

Vencorp Submission for Revenue Cap

The Vencorp submission raises several critical matters of regulatory principle for the ACCC in relation to fair and equitable treatment of other TNSPs vis-à-vis Vencorp:

- the exposure (or lack thereof) to the risk of asset (and hence revenue) optimisation resulting from transmission investment decisions;
- the exposure (or lack thereof) to the risk of changes in the cost of capital over the regulatory period;
- the exposure (or lack thereof) to the risk of changes in the cost of capital beyond the regulatory period;
- the appropriateness of asset lives and depreciation costs; and
- the notion that pass-throughs can be justified on the basis of the capital structure of the TNSP.

It is clear that if the ACCC accepts Vencorp's submission in these areas, it will be creating significant inconsistencies in its treatment of TNSPs, and in the potential outcomes for the customers.

Notwithstanding the unique structural arrangements in Victoria, it is unacceptable if that uniqueness should result in such differing treatments. Whilst we do believe that the treatments of TNSPs in these matters must be equitable, we are not suggesting that such equitable treatment should necessarily be achieved by imposing unreasonable conditions on Vencorp – indeed, achieving equitable treatment may well require that the ACCC re-visits the way it treats the other TNSPs.

It is not unexpected that the need to re-visit the regulatory approach should arise at this time, as this first application by Vencorp to the ACCC represents the first real opportunity that TNSPs have had to be able to see the detail of these regulatory arrangements.

Optimisation risk

Vencorp's submission does not provide information for the ACCC to conduct an optimisation exercise on the assets which result from its investment decisions. Further, implicit in Vencorp's statement about optimisation on *page 44* is that even should an optimisation be performed, then Vencorp would seek to be quarantined from any adverse financial impacts. In essence, this requires the ACCC to exempt Vencorp from the optimisation risk faced by other TNSPs on similar investment decisions.

Whilst Vencorp has not specifically provided any justification to support this exemption, it has, elsewhere in the submission, suggested that the ACCC should "get comfort" from Vencorp's situation that all investment decisions are efficient.

However, an analysis of the comparisons between Vencorp's situation and other TNSPs shows that there are no material differences which would support that exemption.

Vencorp states that all investment decisions must pass the Regulatory Test – this applies to all other TNSPs, who despite having passed the Regulatory test, must still face optimisation risk on those assets.

Vencorp states that its Board also acts to ensure efficiency; yet other TNSPs also have independent Boards. Vencorp's suggestion that its Board acts as "the forum in which the potentially conflicting interests of market participants and other stakeholders are independently assessed" could only provide more robust outcomes if the directors adopted a "sectoral interest" position – other statements from Vencorp indicate that the directors – like their counterparts in other TNSPs – are independent and act in accordance with Corporations Law. In short, this "feature" does not represent a material point of distinction.

Vencorp states that <u>some</u> of its investment decisions involve contestable bids for providing the facilities/service. Since about 90% of the capital costs of <u>all</u> augmentations of other TNSPs also involve contestable bids, this hardly represents a material point of distinction. It does not allow the other TNSPs to escape the scrutiny and risk of optimisation.

Indeed, much of the practice of optimisation relates to whether the facility/service has been "over-specified" for the need, and the application of optimisation to other TNSPs has revolved around scrutiny of that aspect. The specification of the facility/service is not contestable—it is a monopoly activity of Vencorp—as it is for other TNSPs.

To use an analogy, a key focus of optimisation is to ascertain whether the TNSP specified a Rolls Royce, when a Falcon Ute would (with the benefit of hindsight) have done the job. Vencorp's contestability arrangements do not guard against this – they merely ensure that bids are obtained from a number of Rolls Royce dealers.

It is accepted that both the Regulatory test process and Board review provide "at the time" scrutiny of Vencorp's decisions – but the same applies to other TNSPs.

In summary, there are no material differences which should result in the ACCC treating TNSPs differently in relation to exposure to optimisation risk on their investment decisions.

Of course, as a non-profit entity with negligible assets, Vencorp would seek to pass through to customers any loss of revenue resulting from an asset optimisation, whereas for other TNSPs this cost is borne by the owners, not the customers. That might explain Vencorp's commercial position in relation to avoiding optimisation risk (or passing it through), but it cannot be used by the ACCC to justify treating TNSPs differently in relation to optimisation.

It should be noted that we do not have any data to suggest there is a case for optimisation of any particular assets – our position is one of ensuring that the regulatory principles are applied equitably.

The only equitable position is to either:

(a) apply optimisation (with the benefit of hindsight) to all TNSPs without exception, with no opportunity of pass through to customers; or

(b) accept Vencorp's argument that "at the time" processes such as the Regulatory test and Board review represent sufficient scrutiny, and get rid of optimisation risk for all TNSPs.

Whilst Vencorp might, because of its capital structure, argue a theoretical case against (a), one would expect that if Vencorp's decision-making processes are as robust and "comforting" as they assert, then surely the actual risk to Vencorp would be negligible?

Cost of capital during the regulatory period

Vencorp has argued for a pass-through arrangement in instances where the actual costs of augmentations exceed Vencorp's present day estimates, which are based, inter alia, on present day estimates of what the ACCC might determine as the appropriate cost of capital.

Thus, should the cost of capital in later years be higher than at present, Vencorp seeks to pass that higher cost through to customers.

However, this is a treatment which is not afforded to other TNSPs, for whom the ACCC sets a fixed cost of capital applicable at the time of the reset, and which applies to all future investments within the reset period. If the cost of capital increases in the later years, it is the owner, and not the customer, who bears the cost burden.

This is clearly inequitable.

The only equitable treatment is either:

(a) fix the cost of capital upfront for all TNSPs and don't allow pass throughs; or

(b) enable all TNSPs to have pass-throughs if the cost of capital changes during the regulatory period.

It would be relatively simple to achieve (b) through a pre-set indexation formula.

Cost of capital beyond the regulatory period.

It is apparent that Vencorp enters into long-term (covering multiple regulatory periods) contracts with asset owners who successfully bid for that particular contract. Implicit in those bids is the owner's cost of capital (at the time of the bid).

Under the Vencorp arrangements, the owner's cost of capital is guaranteed for the life of the contract – across many regulatory periods.

When interest rates fall, the owners can re-finance and retain the "windfall" gain.

This (favourable) treatment is not provided to other TNSPs whose WACC is reset every five years. In essence, reductions in interest rates are passed through to customers, not retained by the TNSP. In addition, other TNSPs face the general trend of "tightening WACCs", which reflect changes other than changes in interest rates.

Again, this is clearly inequitable.

The only equitable treatment is either:

(a) provide all TNSPs with the opportunity to index their revenues to cover interest rate movements over the life of the assets; or

(b) require Vencorp to index the revenues in its long term contracts to reflect interest rate movements, and reset the WACC every five years as for other TNSPs.

Implied depreciation and life of assets

In the case of other TNSPs, the ACCC makes explicit decisions about the allowable life of assets and the allowable depreciation.

In Vencorp's case, the life of assets and depreciation charge are implicit in the long-term contracts it enters with asset owners.

Are these contracts efficient in terms of asset life/depreciation charge?

Or are the asset owners obtaining, at the expense of customers, an accelerated depreciation over the length of the contract (which may well be much shorter than the asset lives which the ACCC allows for other TNSPs)?

What process does the ACCC apply to protect the interests of customers in this area?

It may be that this is also part of the optimisation exercise i.e. are the contracts which Vencorp enters into optimal in terms of the length of contract, or do these give rise to depreciation costs which are higher than the ACCC allows other TNSPs for similar assets?

Pass-throughs and capital structure

Overall, it appears that Vencorp is seeking to pass through to customers a range of regulatory risks which other TNSPs have to bear. In essence, whereas the costs of what are vanilla regulatory risks under the ACCC's regulatory principles are, in the case of other TNSPs, borne by the owner and not passed through to customers, Vencorp seeks to pass these through to customers.

Vencorp's sole justification for this is its capital structure (specifically, insufficient capitalisation to wear these costs).

This raises an important equity issue – is the ACCC going to provide other TNSPs with relief from these same regulatory risks, on the basis of capital structure?

By way of example, for a TNSP with a highly leveraged capital structure, adverse outcomes from these same regulatory risks may result in that entity breaching its debt covenants. The owners of that business would be forced to re-capitalise the business (e.g. via equity injection) to manage what are vanilla regulatory risks in the ACCC regime for TNSPs.

Will the ACCC provide relief for other TNSPs who have to re-capitalise their business in the wake of adverse regulatory outcomes?

Or is it sounder policy to argue that capital structure is a decision of the owners of the TNSP, and customers should not be asked to wear the costs of adverse regulatory outcomes?

Fundamentally, if an owner wants to be in the regulated TNSP business, it is incumbent upon that owner to establish that business, including its capital structure, to be able to manage those risks. If an owner elects to under-capitalise the business, it should be the owner, and not customers, who must address that.

Either way, the treatment must be consistent for all TNSPs.

Conclusion

The Vencorp submission raises several fundamental issues in relation to the equitable application of the ACCC's regulatory processes for all TNSPs.

It is imperative that the ACCC applies its principles equitably, and it may be necessary for the ACCC to re-visit some of the principles and their application to achieve this.

We would be pleased to discuss these matters in more detail.

Yours sincerely

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CHIEF EXECUTIVE