EMRF Comments On

ACCC's Supplementary Draft Decision On Capex:

Review of regulated costs for 2004-2009

For Transgrid and Energy Australia

1. The Current Regulatory Process Is Unsatisfactory.

According to the ACCC, its Supplementary Draft Decision on Transgrid has been undertaken against the framework specified in the Statement of Regulatory Principles (SRP) and with parts of the framework for assessment agreed with Transgrid prior to the release of the SRP; however, the ACCC then states that the format:-

> "differs from the SRP" (Page 12).

We then question that if the decision was made to vary from the format set by the final released SRP, what has been the value in delaying the Transgrid final decision for over 9 months, creating confusion and delays.

It is difficult to understand what was agreed with Transgrid prior to the release of the SRP and hence the likely impact on the regulatory revenue determination and on major end users. Furthermore, the ACCC states that:-

> "… Transgrid has had to accelerate the identification and costing of the projects and has had limited time to implement practices designed to accommodate the introduction of the ex ante regulatory regime. The tight timeframe has also meant that the full range of alternative project evaluation may not have been thoroughly explored in certain areas" (Page 20).

The EMRF considers the above statements by the ACCC to be descriptions of a highly unsatisfactory regulatory process. It appears to lack clarity and coherence, and seems "rushed" with possible deficient evaluations of capex projects. The outcome is thus, extremely difficult for consumers to assess, with the result that the ACCC has effectively disenfranchised informed consumer comment into the process. As a result, consumers can provide no real support or criticism of the draft capex decision, and thus the ACCC is fully exposed to criticism of acting as both regulator and as surrogate consumer.

This latest review is an example (the review of the 2002 GasNet application is another notable example) in which there seems to be an appearance of inadequate preparation for the review by the ACCC. The supplementary draft decision on capex would seem to be a second review of capex by the ACCC, albeit within (or is it different to?) the framework of the SRP.

The ACCC must take note of the concerns expressed here, as the bottom-line outcome from this type of regulatory process is that it threatens the credibility of the review and exposes it to potential appeal. As consumers effectively fund both the regulatory review and the costs incurred by the regulated business, a possible end result is that end users will have to foot the bill of all costs through no fault of their own.

The EMRF notes with interest that TG originally claimed some $1.4B capex for the period under review. After the ACCC advised that TG was to review its capex under the new SRP, TG increased its already high capex request to $2.2B and the ACCC has awarded some $1.8B of capex, an increase of 30% over what TG believed was necessary in its original application. This same phenomenon is observed with relation to the EA approved capex program.

As a point of interest, TG advises that much of the capex increase relates to new connections for generation. Our review indicates that this presents two fundamental issues

a. Why is the regulated revenue being increased to pay for new generation connections, as these should be paid for as "customer" connection costs (ie by the generator, and not by consumers, and
b. The NEMMCo statement of opportunities does not indicate that this generation is unlikely to be needed during the period as the generation is not scheduled in the SoO.

It now seems that the new ACCC way of assessing capex has created an environment where the transmission businesses can request even greater amounts of capex approvals, without the compensating analysis of demonstrating the efficiency and prudency of the capex program.

2. <u>Creating Competitive Electricity Markets.</u>

The EMRF has been concerned, and continues to be extremely concerned, with major aspects of the National Electricity Market:-

- the weak inter-connection between States;
- the concentration of generator ownership and the ability to exercise market power in most regions;
- the inappropriate wholesale trading system which permits generators to withdraw capacity mechanisms;
- and the high level of value of lost load.

All of these issues create risk and uncertainty in the market and greatly disadvantage consumers. The outcome of these is that consumers are incurring costs that are unnecessary and totally at odds with the original concept of eliminating monopoly rents and inefficient practices.

For these reasons, the EMRF has consistently supported the building of strong interconnections to minimize the exercise of market power and to reduce price volatility in the National Electricity Market. Thus the EMRF has strongly supported the construction of strong inter-regional interconnection (between NSW and Snowy/Victoria, between NSW and Queensland, and NSW and South Australia. As suggested by Dr Rob Booth at the ACCC's public conference regarding this issue, estimates of the cost of interconnection projects may be a little over $1/MWh, which providing they actually deliver the required service (but for example which Murraylink does not appear to do) is a relatively small price to pay in order to eliminate the frequency of price spikes and add a little more competitive pressures in regional markets.

The EMRF, therefore, supports Transgrid's proposal to include the Western 500kv project in the ex ante allowance. It is unclear on what basis the ACCC is proposing to include this project in the "excluded projects" category, given the net benefits that will accrue from better interconnections in the National Electricity Market.

On the other hand, the EMRF notes that two other projects proposed by Transgrid to augment interconnector capacity are included in the "excluded projects" category, but that Transgrid has not proposed triggers for initiation of these projects. The EMRF is somewhat surprised with this, consistent with its general support for stronger interconnection in the NEM. Transgrid should be required to provide an explanation of its processes and initiation requirements. We require to know if the lack of this information is due to concerns about Transgrid's own capacity to realistically undertake such large capex programmes over the next regulatory period.

This issue is extremely important in light of the challenges transmission and distribution businesses are continually referring to regarding access to resources to complete the large amount of capex projects being permitted by regulators in all jurisdictions. Over commitment of capex across the NEM will have three major implications:-

a. The cost of each project will increase above reasonable levels due to competition for scarce resources
b. Shortage of resources will delay project completions reducing the net cash benefits of the capex expenditure
c. Consumers will be paying for the return on capex included in the revenue, but which does not deliver the benefits to the consumers they are paying for.

The ACCC has a responsibility and obligation to ensure that any capex included in the revenue has a high likelihood of being completed on time and to the amount included in the cost benefit analysis. If time or costs increase because the capex program is essentially impossible to achieve, it is better to fully exclude the projects until there is likelihood that the project will deliver the benefits underpinning the proposed expenditure.

3. <u>Capex Levels</u>

The EMRF notes the ACCC's concept of "Excluded Projects" and agrees that it may reduce the magnitude of regulatory gaming and possibly contribute to more efficient capital investments. For example, it is noted that both Transgrid and Energy Australia have sought unprecedented levels of capex, with Transgrid reqesting $2.15 billion and Energy Australia requesting $280 million. These levels are some 100% and 140% respectively over the previous levels of capex spend respectively.

Transgrid's actual investment over the previous regulatory period was some $180 million higher than the $885 million approved in 1999 by the ACCC. In the case of Energy Australia, its actual capex was $116.3 million in 2000-2004, substantially exceeding the ACCC's approved capex of $57 million. Much of this over-run has been accepted by the ACCC as legitimate to roll into the RAB.

It is noted that the ACCC has assessed that Energy Australia's proposed substantial increase in replacement capex cannot be fully justified given that the proposal was based on replacing assets before the assets' condition warranted it. The EMRF supports the ACCC's draft decision, especially in the light that evidence of this had been provided by Energy Australia's condition and risk assessment.

The impact on consumers of the new levels of capex awarded has the following costs

a. TG and EA sent $1.35B on capex last period, which cost consumers some $400m for the last period, and adds about $135m per year into the future.
b. TG and EA requested capex approval of $1.6B in the new period which would cost consumers some $500m in return on capex for the new period, and adds $160m per year into the future
c. After being allowed to revise their capex requirements TG and EA requested capex approval of $2.5B, which would cost consumers $750m over the new period, and adds some $250m per year into the future
d. The ACCC DD approves some $2B of capex for TG and EA, adding a cost to consumers of $600m over the period and $200m per year into the future.

The net cost to consumers of the new arrangement is that the ACCC has successfully encouraged TG and EA to increase costs to consumers from the current level $400m for the period by an additional $200m for the period to $600m, and instituting a forward cost increase from $135m pa by an increase of $65m pa to $200m pa.

Against this backdrop of massive cost increases, the ACCC has not secured any increase in performance standards, or provided a compensating reduction in other areas (such as opex, generator competition or significantly enhanced interconnection. On this basis the ACCC has failed to acknowledge consumers' interests, and by increasing the confusion and complexity by using the new approach, has effectively made it even more difficult for consumers to enter into the debate on the costs they have to pay.

4. Capex/Opex trade off

In its responses to the ACCC EMRF pointed out that there is a close relationship between opex and capex. The greater the capex, less opex is required to manage the introduction of capex. The ACCC has greatly increased the approved capex above that originally sought by some 30%, and done so in isolation. But the ACCC has made no compensating adjustments to the opex awarded to the transmissions businesses as a result. This is a poor outcome for consumers.

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