

19 November 2004

Our Ref: CMELE/0020
Your Ref: 2504

Mr Sebastian Roberts
General Manager – Electricity
Australian Competition & Consumer Commission
GPO Box 520J
MELBOURNE VIC 3001

Dear Mr Roberts

**ACCC Transmission Ring-Fencing Guidelines –
SPI PowerNet Pty Ltd Request for Waiver**

I refer to your letter dated 11 October 2004 inviting the Essential Services Commission (Commission) to comment on an application from SPI PowerNet Pty Ltd (SPI) for a waiver from the obligations contained in clauses 7.1(a)(ii) and 7.6(b) of the ACCC's *Transmission Ring-Fencing Guidelines* (Guidelines).

The Commission considers that the matters discussed below should be considered by the ACCC before a decision is made about the granting of a waiver to SPI.

Potential future contestability of transmission businesses

The electricity transmission and distribution businesses in Victoria are currently regulated as natural monopoly businesses by the ACCC and the Commission respectively using traditional building blocks price/revenue cap methodologies. While distribution is likely to remain a natural monopoly business for the foreseeable future, there are reasons for anticipating that transmission may become an increasingly contestable service in future. While this point can be elaborated further if necessary, some of the relevant considerations are:

- Distributors deliver power directly to large numbers of end-users using meshed networks that are subject to economies of density in operation and network augmentation which tend to reinforce the natural monopoly supply conditions and limit the scope for entry and contestable supply.
- Transmission businesses provide bulk transport services from supply sources to demand centres, usually via a few large customers (including distributors) and are much more exposed to contestability from alternative sources of energy supply or transportation capacity.

- Alternative approaches to the regulation of transmission services may also emerge in the medium term increasing commercial and contestable pressures on TNSPs by integrating transmission pricing more closely into the wholesale market pricing arrangements, for example by means of a move towards zonal or nodal pricing of congestion and losses and secondary market trading of financial transmission rights.

Accordingly, while it is reasonable to expect that electricity distribution will continue as a regulated monopoly business, there is a reasonable basis for expecting significant change in the market and regulatory environment for the future supply of electricity transmission services.

For this reason, the ACCC should give careful consideration to the longer-term risks to the electricity market structure, competition and performance that may result from permitting closer integration of a natural monopoly distribution business with a potentially contestable transmission business. Specifically, consideration should be given to the longer-term implications for competition and efficiency in an increasingly contestable market for transmission services of removal or dilution of ring-fencing requirements between distribution and transmission businesses that are currently subject to direct price cap regulations but are likely to diverge in this respect in future. Having approved a waiver in this case, it would be difficult to reimpose at a later stage and may become an obstacle to the development of a more contestable market for transmission services in future.

Potential for discriminatory conduct

Apart from these longer-term market issues, consideration will need to be given to the potential for SPI's transmission business to favour its affiliate distribution business relative to other distributors in the provision of transmission services. As a general proposition, such discrimination could distort resource allocation and investment decision-making in the network and energy sectors and impose financial costs on other market participants.

While this potential would be partly reduced by the planning function performed by VENCORP and by some proposals in SPI's application seeking to address the potential for discrimination in relation to connection asset and outage planning, the possibility of discrimination in relation to unplanned power outages remains.

The following examples illustrate this general concern:

- SPI's waiver application has not addressed the potential for favouring TXU with higher supply restoration priorities that could (1) avoid costs through lessening customer complaints, (2) re-establish tariff revenue more quickly, (3) re-establish a secure supply more quickly and hence lessen the potential for multiple outages resulting in widespread supply interruptions and (4) impose commensurate costs on other distributors, retailers and customers receiving lower priority.
- There is also the potential for SPI and TXU to increase profits by carrying out unnecessary augmentation of transmission connection assets. Such a situation may arise because DNSPs initiate the process of augmentations to transmission connection assets and the Commission's 2001-05 Electricity Distribution Price Determination allows DNSPs to pass through costs from the TNSP. This means that under the planning arrangements in Victoria, TXU could request SPI to

undertake works which are funded by TXU and whose costs can be passed through to customers, without the need to pass any regulatory test. While the potential for such conduct currently exists, it is less likely to occur between legally separated businesses that are driven by separate incentives. The ESC's role in examining these transactions would need to be significantly increased if the waiver was granted.

- SPI's waiver application notes that SPI could favour TXU when unplanned outages occur, such as when storms or connection asset failures interrupt supply. It states that interruptions caused by the failure of transmission connection assets are likely to be exempted from the DNSP's S-factor scheme, and there is thus unlikely to be any financial impact on the DNSP. However, as these interruptions are also exempted from the TNSP's performance incentive scheme, the Commission is currently considering – as part of the 2006-10 Electricity Distribution Price Determination – whether they should continue to attract an exemption from the DNSP's S-factor scheme. If it is decided to remove the exemption as a general improvement in incentive properties of the regime there would be an incentive for SPI transmission to discriminate in favour of TXU distribution with adverse financial consequences for other distributors.

Accounting separation obligations

In its waiver application, SPI states that any concerns about cross-subsidy and inappropriate cost allocation should be alleviated by the fact that both the transmission and distribution businesses are required to demonstrate compliance with ring-fencing requirements. It also states that SPI will continue to be bound by the regulatory accounting information requirements of both the Commission and the ACCC, and the fact that the respective regulatory accounts will be audited annually will assure compliance with respect to the accounting aspects of ring-fencing. The Commission notes that ring-fencing can take the form of legal separation, operational separation and/or accounting separation. While auditing of regulatory accounts may provide some assurance in relation to accounting separation, it does not provide any assurance in relation to operational separation. The risks associated with an absence of operational separation have been discussed above.

If the transmission and distribution businesses of SPI are no longer required to be legally separated, then an effective audit of the transmission and distribution regulatory accounts would require both sets of accounts to (1) be audited by the same auditor, (2) be based on the same financial year, (3) use similar headings for ease of reconciliation, and (4) be available to both the Commission and the ACCC.

Importance of legal separation

The ACCC should also reflect on the more fundamental role that the legal separation requirement in clause 7.1(a)(ii) plays in the operation of the Guidelines and the potential for a waiver from compliance with that requirement to substantially weaken the remaining ring-fencing obligations that would apply to SPI. A number of the major requirements contained in the Guidelines – including non-discrimination in clause 7.2(b), information sharing in clause 7.6(a), preferential treatment through sharing of operational activities in clause 7.6(b) and separation of marketing staff in clause 7.7 – rely on the definition of 'associate' in the *Corporations Act* (Cwlth).

If the legal separation requirement is waived by the ACCC, SPI's transmission and distribution businesses can operate within the same legal entity and they will therefore not be 'associates'. In that case, the ring-fencing requirements contained in the clauses referred to above will be ineffective in their application to SPI's transmission and distribution businesses and the net effect of the waiver will be to waive the key requirements of the Guidelines.

Test for waiver of ring-fencing requirements

Clause 11 of the Guidelines sets out the test for assessing waiver requests. It provides that the ACCC may 'waive any of the TNSP's obligations under clause 7 provided that that ACCC is satisfied that the benefit, or any likely benefit, to the public is outweighed by the administrative cost to the TNSP and its associates of complying with the obligation'. The interpretation of the test intended by the ACCC is not entirely clear, particularly regarding the relevant costs and benefits.

SPI, for example, argues that the term 'administrative costs' can be interpreted broadly as the costs that would be incurred by SPI in maintaining the status quo relative to the (lower) costs that would be incurred if the transmission and distribution businesses were to combine their operations (including synergies estimated to result from integrating aspects of the network businesses).

The Commission considers that the 'public benefits' to be considered under the waiver test should be the 'net public benefits' expected to arise from approving the waiver. That is, any resulting efficiencies (including potential synergies and the reduction of guideline compliance costs) from allowing integration of the two network businesses should be set against any resulting wider public benefits or detriments (including for example any positive or adverse impacts on future competition and resource allocation including those referred to above). This seems to be a more appropriate way of analysing the waiver proposal from first principles although the approach does not flow obviously from the wording of clause 11.

In any event, the interpretation of clause 11 adopted by SPI is inappropriate and confusing.

As well, SPI has not presented sufficient evidence to satisfy the net public benefit test. In its waiver application, SPI acknowledges that 'at this time the detailed analysis necessary to reveal an optimum corporate services arrangement has not been performed' and it states that 'it is not desirable to undertake this step without greater certainty of the waiver being granted'. The Commission considers that SPI must provide further evidence of the actual and potential public benefits associated with the granting of the waiver.

Conclusion

The Commission suggests that the ACCC consider interpreting clause 11 as requiring an assessment of SPI's waiver application on the basis of a net public benefit test. As part of this assessment of the net public benefit arising from granting the waiver being sought, consideration should be given to both the potential efficiencies to be extracted by SPI from integration of the two network businesses and the risks to competition that may result from the granting of the waiver.

If you have any queries or require further information in relation to the matters discussed in this letter, please contact Paul Fearon, Chief Executive Officer, on (03) 9651 0211.

Yours sincerely

[signed]

JOHN C TAMBLYN
Chairperson