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Dear Sebastian

EUAA Comments on ACCC Revised Draft Statement of Principles for the Regulation of Transmission Revenues

The Energy Users Association of Australia (EUAA) appreciates the opportunity to provide a submission to the Australian Competition and Consumer Commission (ACCC) on its Revised Draft Statement of Principles for the Regulation of Transmission Revenues.

The attached submission sets out our views on the Revised Draft Statement of Principles for the Regulation of Transmission Revenues. The views are formed solely on the basis of what is in the best interests of energy users. The EUAA is uniquely placed to provide the ACCC with such a view, given its involvement in both national and state issues and its position as the national association of energy users.

If you have any queries regarding our comments you can contact Con Hristodoulidis, EUAA Director Policy and Regulation on telephone number (03) 9898 3900 or e-mail con.hristodoulidis@euaa.com.au.

Yours sincerely

Roman Domanski
Executive Director

EUAA Submission on
ACCC Revised Draft Statement of Principles for the Regulation of Transmission Revenues

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1. INTRODUCTION

The Energy Users Association of Australia (EUAA) appreciates the opportunity to provide comments to the Australian Competition & Consumer Commission (ACCC) on the Revised Draft Statement of Principles for the Regulation of Transmission Revenues.

The EUAA would also like to thank ACCC staff for providing the EUAA and other end user organisations with a detailed briefing of the changes to the revised draft Statement of Regulatory Principles (DRP) on Friday 1 October 2004.

As you may be aware, the EUAA is a non-profit organisation focused entirely on energy issues on behalf of large business end users of electricity and/or gas. The EUAA currently has approximately 75 members. Membership ranges across a number of sectors, including mining, manufacturing, construction, commercial property and service sector. Many of the EUAA's members operate across States.

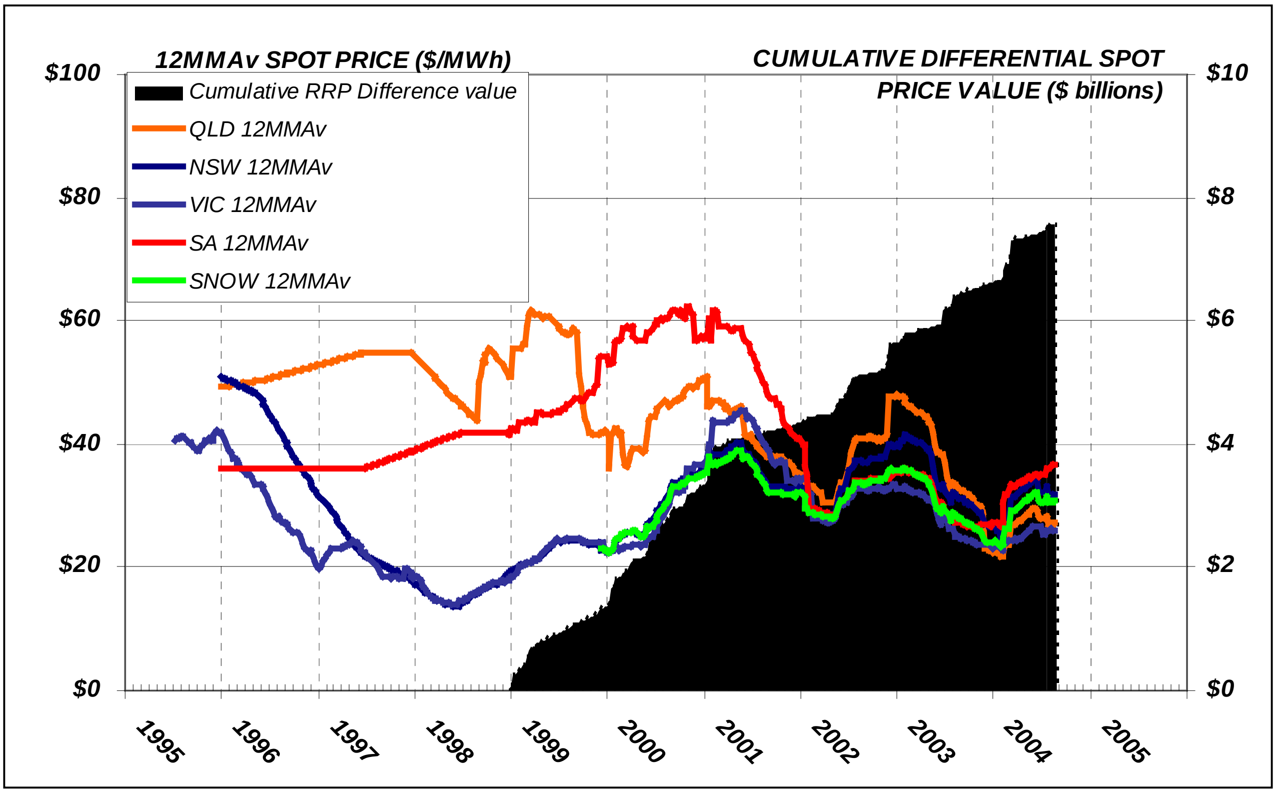
The EUAA has been an active participant and contributor to the ACCC process of developing the Statement of Principles for the Regulation of Transmission Revenues. Our input includes a detailed submission (with the Energy Action Group (EAG)) that we lodged with the ACCC in February 2004. The National Electricity Consumers Advocacy Panel funded the submission.

Our response to the revised ACCC DRP is in two parts. The first section outlines in general terms the benefits to end users from a truly national transmission network. The second section makes specific comments on the revised DRP benchmarked against the EUAA/EAG February 2004 submission.

2. End User Benefits from a National Transmission Network

Last year the EUAA published estimates that interconnector constraints in the NEM had costing end users around $6B, based on the impact that constraints had on regional pool price differences (allowing for transmission losses). An update of this cost to customers presented by the EUAA Executive Director in his speech to the EUAA's recent Annual Conference puts the number now at $7.6B and it is expected to reach $8B by the end of 2004. This is a source of major concern to energy users and a continuing blight on the performance of the NEM. See Diagram 1 below.

Diagram 1: Cost of NEM Transmission Constraints



Source: Marsden Jacobs Associates.

Dr Rob Booth of Bardak has examined the Annual Transmission Statement (ANTS) and estimates that it contains proposals for approx $2.4B in transmission interconnector investments in the NEM. This would make a big impact on alleviating interregional transmission constraints in the NEM, a major cause of high prices, volatile prices and the ability of generators to benefit from the exercise of market power[1]. Yet these upgrades would add only 1.4% to transmission charges, which account for only 10% of the average bill (that is they would add only 0.14% to the delivered price of power).

The EUAA acknowledges that the $8 billion 'black hole' would not completely flow to consumers through lower wholesale market prices if all transmission constraints were removed. For a start, the generators could change their bidding and contracting behaviour and prices in the exporting region may rise. However, these impacts would be relatively minor. The main point is that using simple assumptions, it is possible to estimate (under current bidding arrangements) a notional value of the impact on the energy market of transmission constraints.

In the revised ACCC Regulation Test for Investment in Transmission Expansion (the Regulatory Test), the ACCC for the first time introduced a 'competition benefits' test.

[1] The EUAA is conscious that improving transmission interconnection without addressing the structure of generation in New South Wales and Queensland would mean that avoidance of price spikes would be totally dependent on contracting arrangements between generators and retailers. In addition, continuation of ETEF in New South Wales and BPA in Queensland would still tend to corrupt the contract market. Hence, we have called for the removal of ETEF and the BPA, and for the inclusion of generation ownership and structure to be added to the MCE agenda as a matter of priority.

The ‘competition benefits’ test attempts to evaluate the impact of NEM market participants’ behaviour and NEM pricing outcomes from a transmission augmentation.

Notwithstanding this step, we still have strong reservations about the practical impact of the ‘competition benefit’ test in alleviating transmission constraints, as the test developed does not go far enough. The problem with the revised test is that it does not count the costs of constraints in the form of higher electricity prices that are imposed on customers and used to reward generators. Our strong view is that this is not a market “transfer” in the classic economic welfare sense, but a penalty on trade exposed industries using energy to compete. That is, it is a “wealth” transfer away from the sectors of the economy most exposed to international competition.

Hence, the EUAA strongly recommends that the ACCC further develop the Regulation Test so that end user benefits of reduced interconnector constraints are captured. A broader ‘competition benefits’ test that takes into account the cost of constraints on end users is more likely to lead to interconnector investment that will make a major impact on eradicating the $8b NEM ‘black hole’ that end users continue to bear.

3. Specific comments on the revised DRP

There are significant end user benefits from undertaking appropriate interconnector investment. However, augmentation investment undertaken by TNSPs to maintain and/or upgrade the TNSP network has to be undertaken in an economic and prudent fashion for end users to derive benefits. This is critical both because transportation of electricity is an essential service and current TNSPs have a natural monopoly in transporting electricity to end users.

Hence, the EUAA welcomes the ACCC general approach to implement an incentive based CPI-X system of setting Revenue Caps for TNSPs that should *prima facie* result in greater efficiencies over time with the benefits flowing through to end users. In light of this, we have some specific comments to make on the following areas of the revised ACCC DRP.

A. Revenue Cap Decision-Making Process

The EUAA welcomes the ACCC’s firmer indications as to its processes and the opportunities for consultation in a typical review.

However, we remain concerned that a number of issues raised in the EAG/EUAA submission in February 2004 still remain unresolved and some matters we raised appear to have been overlooked by the ACCC.

In particular, we are concerned that it appears that the ACCC did not investigate the EAG/EUAA proposal to align the timing for review of all NEM TNSPs as soon as practical and to undertake a regulatory review for a single, multi-company, NEM-wide transmission system. As we stated in our February 2004 submission, aligning the regulatory periods and review processes has the potential to deliver substantial benefits to all stakeholders, including:

- substantially reducing the resources required to participate in multiple reviews, thereby reducing the cost of regulation;
- allowing the ACCC to deal with issues common to all TNSPs, such as –
  - ➢ analysis and judgement on the value of parameters for estimating the weighted average cost of capital in exactly the same way for all TNPS;
  - ➢ assessing the prudency and efficiency of expenditure, and application of comparative performance assessment (or benchmarking) using consistent data;
  - ➢ create comprehensive 'service standards' for the whole transmission system that could include specific incentives for TNSPs to interact with the energy and ancillary services markets to optimise outcomes for end-users;
  - ➢ create better targeted incentives for all TNSPs to operate efficiently, including through 'competition by comparison'; and
  - ➢ provide for enhanced consistency with the regulation of distribution networks by jurisdictional regulators, which is moving to a national basis under the MCE reforms.

Finally, we also remain concerned that the ACCC did not include in the revised DRP a commitment to work with TNSPs to improve the communication of their tariffs to customers, retailers, distributors and jurisdictional retailers and to require them to develop some 'tools' to assist with this.

The tariffs that emerge from ACCC revenue determinations impact directly on end users, yet they are removed from any involvement in setting them, are susceptible to monopoly pricing abuse and the communication of new tariffs to end users is in need of improvement. This is highlighted in several problems that emerged after the implementation of new tariffs following the ACCC's recent decision on Transend, a matter drawn to our attention by several members. The ACCC needs to engage more in this issue without getting into micro-management.

B. Asset Base

The EUAA supports the ACCC draft decision to shift away from a periodic revaluation of the asset base to a lock-in. The ACCC has previously argued that there is a hypothetical benefit to consumers if TNSP's are subject to the risk of revaluation because this is supposed to act as an incentive for them to ensure that all their investments are efficient. The practical outcome of allowing the option of revaluation has universally been that TNSPs have successfully argued for upward valuation, but the ACCC has never assessed, nor the TNSPs, have ever presented a case for, a downward revaluation.

Another fundamental practical problem is that any valuation methodology is information intensive, and all the information comes from the regulated entity. This information asymmetry advantage can only act in one direction. It favours the regulated entity.

The other issue to be considered is that even where regulators have hypothesised that assets could be devalued, they still argued that it was essential that the regulated entity be permitted to recover the stranded asset value through accelerated depreciation. This means that customers pay even where the regulator determines that the investment is inefficient. The essential logic supporting this position is that to do anything else increases the investment risk which in turn supports arguments to increase the WACC, which would increase cost to consumers more than the cost of paying for the stranded asset.

C. *Incentive Framework for Capital Expenditure*

The ACCC proposes to shift from an *ex-post* to an *ex-ante* prudency assessment of capital expenditure by TNSPs. Under the *ex-ante* approach, the ACCC will undertake a forward-looking assessment of investment requirements over the regulatory period. The ACCC state such an approach is less intrusive and allows TNSPs to freely decide on the size and timing of its projects to meet its statutory obligations. At the end of the regulatory period, the ACCC will roll into the locked in RAB the lessor of the present value of the total actual investment for the period, or the present value of the profile of annual expenditure specified by the cap.

The EUAA supports, in principle, a light-handed regulatory approach and an *ex-ante* methodology does fulfil this principle. However, it is clear TNSPs hold an information knowledge advantage over the ACCC and end users of transmission services. A light handed regulatory approach whereby TNSPs also have an information advantage provides them with an opportunity to 'game' and therefore the ACCC needs to guard against such an outcome.

For instance, the *ex ante* incentive mechanism provides an incentive for TNSPs to defer capital investment in the first phase of the regulatory period and significantly increase capital expenditure in the second half of the regulatory period. The TNSPs can then use the increase in capital expenditure late in the regulatory period to seek significant increases in capital expenditure in the forthcoming regulatory review. This pattern has been consistently demonstrated in regulatory reviews under the incentive regime both here and overseas.

Hence, while the ACCC would prefer to apply a light-handed approach, the EUAA has some doubts that this will eventuate under an *ex ante* CAPEX incentive scheme. This is because the ACCC will need to apply a 'forensic' evaluation of actual CAPEX from the previous regulatory period to ensure that they are not being 'gamed' for the forthcoming regulatory period.

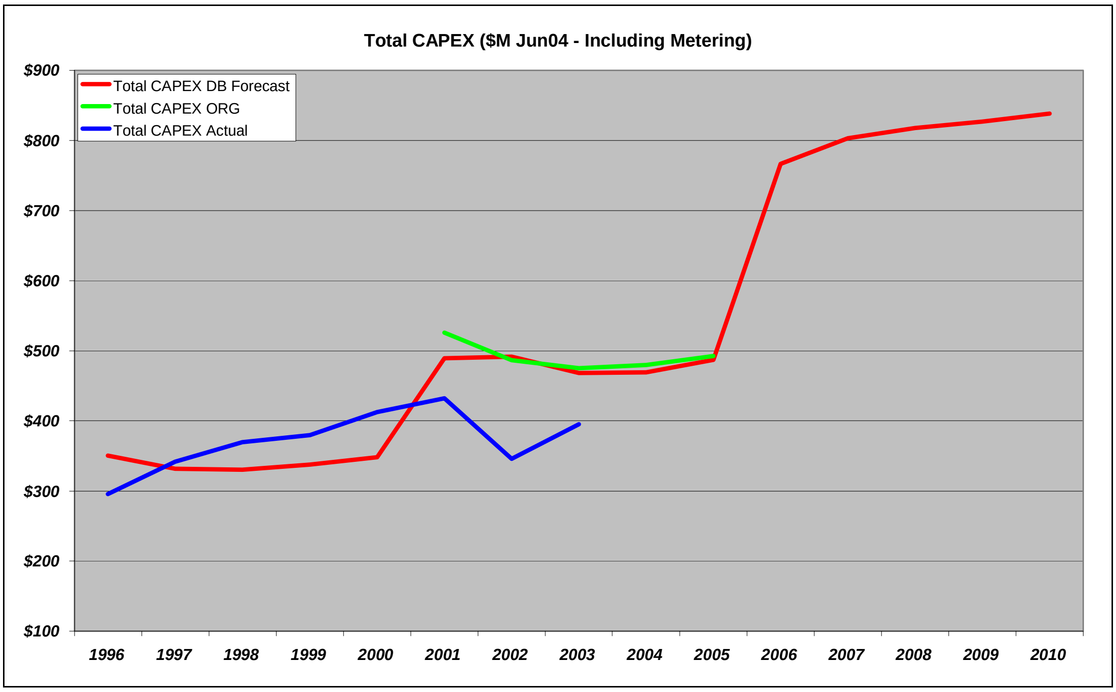
Preliminary data from the 2006 Victorian Essential Services Distribution Pricing Review (which also applies an *ex ante* CAPEX incentive scheme in regulating Victorian distribution businesses) seems to support such an outcome. For example, the Chairman, Dr John Tamblyn, presented preliminary data on actual capital expenditure versus forecast capital expenditure for the 2000 Victorian Distribution Review. Overall, all five Victorian distribution businesses have under-spent on CAPEX against forecast CAPEX at the beginning of the 2000 Review. However, all five distribution businesses have sought significant CAPEX increases in the up-coming 2006 regulatory period. See diagram 2.

The EUAA supports the ACCC proposal to exclude large and unpredictable projects from the cap and assessing these projects at the beginning of the regulatory period. Excluding significant but uncertain investments places a greater onus on the TNSP to justify the prudent need for the expenditure. However, we note the opportunity for TNSPs to 'game' the proposal by seeking to have a project excluded or alternatively included in the ex-ante cap, depending on which approach provides the best outcome. This outcome is noted in the ACCC *Statement of Principles for the Regulation of Electricity Transmission Revenues – Background Paper*. The EUAA believes that the ACCC needs to be vigilant regarding such 'strategic behaviour'.

The EUAA also supports the proposed 'off-ramp' approach for significant and unforseen events. We support the need to define 'off-ramp' events at the time of the revenue reset period. We also support the proposal that an 'off-ramp' event can be invoked by a TNSP, ACCC or third party. However, we recommend that the ACCC define third party to include an end user customer and/or member organization representing a group of end users. We also recommend that 'off-ramps' that result in exogenous cost reductions should be included in any regulatory determination reset.

Finally, the EUAA would like to reinforce the point that TNSPs have an information advantage when it comes to determining an 'off-ramp' and hence it requires the ACCC to be vigilant that exogenous cost shocks in either direction are captured.

Diagram: 2: TOTAL CAPEX ($M Jun04)



Source: Marsden Jacobs Associates

D. Incentive Framework for Operating and Maintenance Expenditure

The ACCC intends to introduce an efficiency carry-over mechanism as an incentive for TNSPs to better manage their operating and maintenance expenditure. The ACCC will also establish a working group by April 2005 to benchmark the performance of

TNSPs and report by October 2006. At the completion of the working group task, the ACCC will make a decision as to what extent benchmarks can be taken into consideration in subsequent revenue cap decision.

The EUAA is a strong supporter for establishing OPEX benchmarks and we believe that the ACCC has not done enough in developing appropriate benchmarks in the first round of regulatory reviews for TNSPs. Users expect more to be done and at a faster pace. Hence, we welcome the ACCC decision to establish a Working Group to begin the scoping of benchmarking the performance of TNSPs.

However, we believe the timeframe of 15-months for the Working Group is far too long. We recommend that the Working Group be given 6-months to undertake the benchmarking process. The ACCC should then use the results of the Working Group to develop a ‘paper trail’ or ‘transparency measures’ (similar to the TNSP service standards approach) benchmarking project with full implementation by the end of 2006.

The EUAA also strongly believes that aligning the regulatory review periods (see section 3A of submission) will greatly assist in developing appropriate OPEX benchmarks.

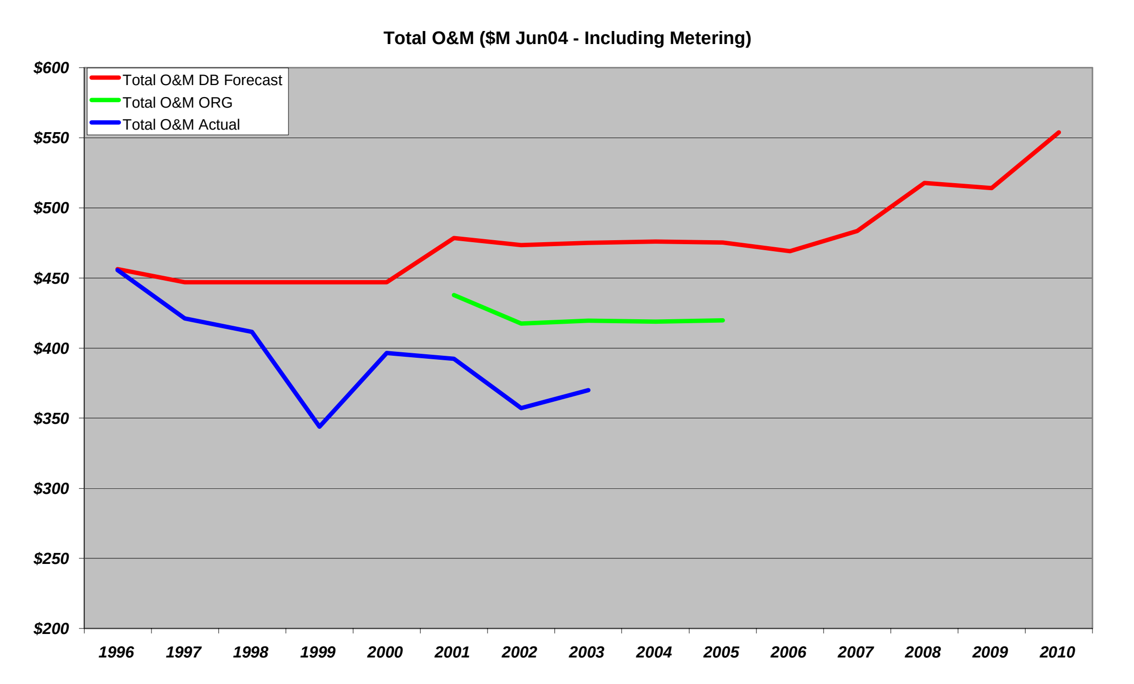
We would also be very keen to participate on the Working Group and as a starting point for the Working Group, we re-state our view from our February 2004 submission that the ACCC should:

(a) Commit to implementation of UK-styled econometric analysis of TNSPs performance, using data and information from consultants’ reports as one of a range of inputs to that analysis.

(b) Use the output of the econometric analysis to establish a rational monitoring and comparative reporting regime for TNSPs that will assist in better informing regulatory decisions.

The EUAA also supports the introduction of an efficiency carry-over mechanism as a means of incentivising TNSPs to achieve efficient operating costs. However, the EUAA would caution the ACCC of strategic behaviour of TNSPs. The Victorian Essential Services Commission applies an efficiency carry-over mechanism. It appears that the Victorian Distribution Businesses have under-spent their OPEX in the current regulatory period compared to the forecasts set at the beginning of the period. However, overall the distribution businesses have sought a substantial increase in their OPEX for the 2006-2010 regulatory period. See Diagram 3 below.

Diagram 3: TOTAL O&M ($M Jun04)



Source: Marsden Jacobs Associates

E. The Weighted Average Cost of Capital

As the EAG/EUAA outlined in the February 2004 submission on the SRP, the approach adopted by Australian regulators to setting return on equity and WACC is a critical issue for energy users (and for energy networks). It is one of the key issues in any review of energy network charges.

Return on capital (*WACC x Asset Value*) accounts for 50% or more of annual revenue requirement of the NSPs and has a commensurate impact on transmission charges. Unfortunately, and inevitably, the importance of WACC to NSPs' revenue provides strong incentives for ambit claims and exercise of 'strategic behaviour' (i.e. gaming of the process, setting of parameters and associated information) by the TNSPs. In the case of Australian TNSPs, a 10 basis point increase in WACC delivers in the order of $20 million per year more revenue. This is a powerful incentive to use every possible means to get regulators to set higher risk adjusted values than required to satisfy the 'reasonable expectations' of financial markets, which should be a key benchmark for regulators.

Hence, the EUAA is concerned that there appears very little change (of any substance) in the revised DRP in the section on WACC. The only concession the ACCC seem to make is to propose estimating the Debt Margin as the difference between the "***moving average of the risk free rate (between 5 and 40 days) submitted by a TNSP in its application***" of the Commonwealth Treasury 10 year Bond Rate and a Debt Market Bond Rate for a A-Rated commercial borrower.

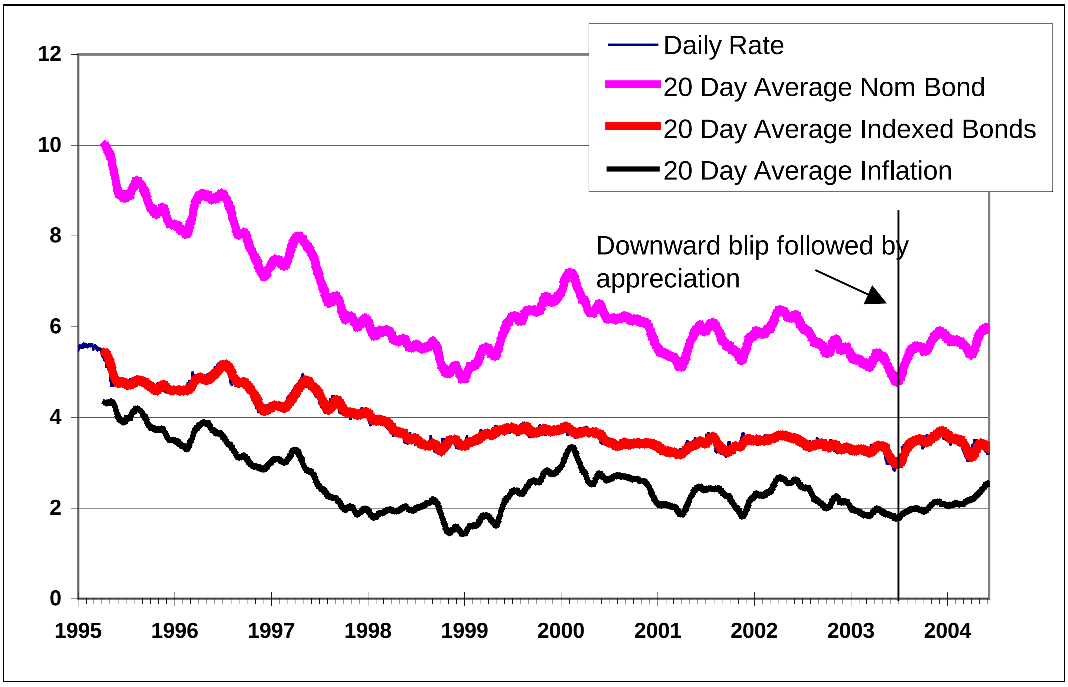
This is much the same approach as that adopted by IPART for the 2004 Electricity Distribution Pricing Review, except IPART set the number of days at 20 and used a BBB+ Rating (the BBB+ Rating would give a slightly higher Debt Margin than an A-Rating, but probably only a couple of basis points). The ESC is proposing the same

(IPART) approach for the Victorian Water sector, which would lower the Debt Margin by around 50 basis points (and "Vanilla" WACC by 20 basis points) compared to decisions in electricity and gas.

We believe that the IPART approach to Rating is rational, given that regulators are aiming to assure "investment grade" Ratings for Network Service Providers.

However, the Bond Rate is relatively volatile and could lead to potential 'gaming' by TNSPs (for example, the downward "blip" in mid-2003 just happened to correspond to one of IPART's decisions, but the 20 day average rose by nearly 90 points within 6 months). See Diagram 3.

Diagram 3: Commonwealth Bond Rates



Source: Marsden Jacobs Associates

The difference between a 5-day average and a 40-day average could be significant and produce variations in WACC of 30-50 basis points. The flexibility for TNSPs to choose between 5 and 40 days to calculate the moving average of the risk free rate seems to be inviting "strategic behaviour" (i.e gambling on the Bond Markets) by TNSPs. It is, in consequence, a non-sensical way to set the Cost of Debt.

This outcome is further exacerbated because TNSPs are significant players in the "contract" Debt Markets, which they actively participate in to manage their debt servicing. However, the Commonwealth Bond Market is, in effect, more volatile than the "contract" Debt Markets.

Hence, such volatility on the Commonwealth spot market invites TNSPs to adopt a strategic approach in choosing a risk free rate that maximises their overall WACC rate and provides TNSPs with better credit rating to participate in the "contract" Debt Markets.

The EUAA recommends that the ACCC should set the length of period used in calculating the moving average to 40 days rather than provide TNSPs with the flexibility of choosing between 5 to 40 days. A 40 day moving average, by its very nature, will be less volatile and therefore less susceptible to ‘gaming’.

The EUAA is also concerned with the setting of actual benchmarks (numbers) for WACC parameters such as the market risk premium, the equity beta and the risk free rate in the DRP. This will only act as a device for the TNSPs (maybe DNSPs if or when they transition to regulatory oversight by the AER) to use these numbers as 'de facto' values or ‘tablets etched in stone’.

Given that there is already a definite thread running through the ACCC’s ‘preferred’ parameters of numbers that lead to high WACCs, it seems to create the conditions for a self fulfilling prophecy whereby TNSPs will *de facto* be guaranteed a certain outcome for the WACC parameters that would be likely to put a floor under these. We strongly believe that putting any numbers in the DRP would most likely work to the disadvantage of energy users and could even stifle debate of what the real numbers should be.

The WACC is one of the most important elements of any regulatory review and it would be highly inappropriate and detrimental to end users to adopt an approach that locks in values in advance of debate on this.

If the ACCC believes that there is no room for further debate on the WACC parameters then it is mistaken. We have consistently outlined our views that the ACCC and other Australian regulators are out of sync with their overseas counterparts in consistently opting for significantly higher market risk premiums and equity betas. We would certainly want to be in a position where this matter can be debated further in future reviews.

Hence, the EUAA remains concerned that the ACCC continues to ignore international benchmarks in calculating appropriate numbers for WACC parameters. This is further compounded by statements by the ACCC that they are aware of emerging evidence that the values they have set for equity beta and market risk premiums in recent TNSP reviews are high but that the ACCC is unsure what the actual value should be and therefore continues to use the inflated value. For example:

> *… market evidence shows regulated firms listed on the ASX have an equity beta of less than 1.0 (after adjusting for capital structure) and thus do not face the same market risks relative to the market portfolio beta. (page 154, ACCC Background Paper on DRP)*