

21 November 2003

Mr Sebastian Roberts
General Manager
Regulatory Affairs-Electricity
Australian Competition and Consumer Commission
GPO Box 520J
Melbourne Vic 3001

Dear Sebastian,

**RE: REVIEW OF THE DRAFT STATEMENT OF REGULATORY PRINCIPLES
FOR TRANSMISSION REVENUES**

Origin is pleased to provide the following brief comments on the above discussion paper put forward by the Australian Competition and Consumer Commission (ACCC) for consultation. Any issues we do not comment upon reflect our general agreement with ACCC recommended positions on these matters. In particular, we support the ACCC's general approach to pass-through rules in relation to insurance and its approach to calculating the cost of capital. However, Origin does have some concerns with the ACCC's proposals with regard to asset valuation and its treatment of capital expenditure. These issues will form the focus of the following brief submission.

1. Revaluation of the asset base versus the merits of roll-forward

The ACCC proposes to accept the Jurisdictional Optimised Depreciated Replacement Cost (ODRC) valuation of the asset base and role in additional capital expenditure at cost. Origin supports use of ODRC as the methodology used to value the regulated asset base of Transmission Network Service Providers (TNSPs) as ODRC most closely resembles the asset value of an efficient new entrant. In a workably competitive market it would not be rational for TNSPs to charge prices above new entrant costs as this would lead to new entry or network bypass. Similarly, revenues or prices below new entrant costs would be commercially unsustainable, leading to some participants to exit the market. Thus

prices set at new entrant levels would reflect long term equilibrium outcomes in a workably competitive market.

However, the ACCC proposes to substitute ODRC revaluation with a roll forward of capital expenditure costs which passes the regulatory test. Origin disagrees with this proposal as this would replace an effectively exogenous determination of a TNSP's capital cost with one largely driven by the TNSPs themselves.

The dependence of the regulator on TNSPs own capacity expenditure valuations would be equivalent to implementing a low powered incentive regime based largely on firm specific costs. However, one of the key benefits of revaluation using an ODRC type methodology is that it would break the link between specific costs of a particular firm and the regulated revenue it receives. Rather such revenue would depend on an industry wide measure of the costs of a hypothetical efficient new entrant, thus significantly reducing the potential and incentive for a TNSP to take advantage of asymmetric information in order to inflate its own costs.

TNSPs would be encouraged to reduce their costs simply because they would be aware of the fact that at the end of the regulatory period, rather than any recalculation of their revenues being a function of their own costs, would reflect the costs of the 'least cost' alternative asset capable of providing the same level service at that particular time. This is consistent with the workings of a competitive market where all firms attempt to reduce their costs to maximise the difference between their own costs and the market price they receive (note that in a competitive market firms have little influence over market price).

The ACCC argues that use of ODRC methodology significantly enhances uncertainty for TNSPs as they face an unpredictable revenue stream which depends upon their cost outturns relative to the ODRC cost benchmark. However, uncertainty is a normal and pervasive feature of business decision making in any market. In the National Electricity Market (NEM) generators and retailers are faced with significant uncertainty about future demand and prices, and the prospect of stranded assets if their predictions turn out to be incorrect. It does not seem unreasonable, therefore, that TNSPs whose operations significantly impact these other entities should not be similarly exposed to such a commercial risks. Indeed, allocating the risk of changing demand and technology to TNSPs appears the correct decision to make as they are in the best position to forecast variability and evolution in such parameters and thence manage the risk.

For instance, a Market Network Service Provider (MNSP) who misjudges demand for its capacity will suffer the financial consequences of reduced flows over its lines; consumers do not pay for any such unutilised capacity, so why should they do so under a regulated regime which itself is predicated on imitating the workings of a competitive market. As a NERA notes:

“In a competitive environment firms earn a return on the current value of their assets, whether or not investment in these assets was appropriate at the time of investing. In a competitive market, businesses bear the risk of technological or market changes that may make their assets more or less valuable. Optimisation, on the basis of existing market conditions and technology is therefore appropriate in a test for abuse of market power”.¹

The last statement in the above paragraph also highlights another key benefit of asset valuation methodologies that attempt to establish the cost of an efficient new entrant, the resultant ability to ascertain the level of monopoly profits being earned. The latter being a key objective of the Chapter 6 of the National Electricity Code (the Code).

While the theoretical advantages of ODRC methodology are probably unchallenged, its key supposed weakness lies in its practical application. Consultants to the ACCC identify a number of difficulties of estimating ODRC in practice, in particular uncertainty surrounding appropriate cost parameters, and the provision that ought to be made within allowable regulated revenues regarding excess capacity. While these are valid concerns using current firm specific or historical based costs as a basis for asset valuation provides no greater certainty in ascertaining the appropriate efficient asset cost. For instance;

“Historical cost valuations provide no information relevant to assessing prices in a competitive market. Book values reflect various accounting practices and potentially different approaches to asset capitalisation and revaluation and are irrelevant to price setting under competitive conditions”²

The regulatory test too is open to considerable subjective judgement on many of its key decision variables, and also relies heavily on TNSPs themselves for key information inputs. Unfortunately, use of historical

¹ Asset Valuation for the Gas Control Inquiry, A report for NGC Holdings, prepared by NERA August 2003

² Ibid

costs and/or the regulatory test for setting regulated revenues creates the added incentive for TNSPs to inflate their costs, while at the same time leaving no benchmark form which to judge whether they are earning excessive monopoly profits.

For these reasons Origin considers that, although recognising the difficulties associated with using ODRC, there is presently no better alternative. Moreover, its accuracy should improve over time with more information and greater experience in its application. Origin notes that ODRC methodology also draws on significant prior precedent, having been applied both in Australia and internationally across gas, telecommunications, rail and electricity markets.

Some of the weaknesses of ODRC methodology can also be substantially mitigated through setting appropriate confidence bands around benchmarked values and implementing error correction mechanisms to compensate for benchmarks which may have been set too low, or too high for that matter. These may include adjustments to the regulatory rate of return and provision for accelerated depreciation. Confidence bands around benchmarks can be adjusted over time as data and experience improves.

In Origin's view a key point is perhaps not so much whether the benchmarked value is perfectly precise but more so that the TNSP is vigilant to the fact that the regulator is attempting to estimate the efficient level of industry cost and so the TNSP should do likewise in order to ensure it maximises its potential revenues. Subsequent judicious tinkering around the edges, through negotiation between the TNSP and regulator, or on some other basis, in order to ensure benchmarked values are not unrealistic is acceptable as long as the key incentive properties are not excessively diluted. In other words, the burden of proof should be on the TNSP to prove that their costs are justifiable in respect of the benchmarks set.

While providing scope for such *ex post* adjustments to 'unrealistic' cost bench marks reduces the incentive properties of ODRC methodology to some extent, this would also mitigate the potential for prices and costs to diverge excessively and subsequently create windfall gains or losses to TNSPs. This may be important, as the credibility of any incentive regime may be significantly compromised if the benchmarks set lead to unsustainable financial distress for the regulated firm (or unsustainable financial gain).

2. Incentives for minimising capital and operating/maintenance expenditure

Operating and maintenance expenditure

Consistent with its views on asset valuation, Origin supports greater reliance on exogenous variables in determining appropriate cost benchmarks for operational and maintenance expenditure. This decouples the nexus between a firm's revenues or prices and its own costs, and thus maximises the firm's incentive to pursue cost reductions.

External benchmarking approaches using either TFP or some measure of the costs of an efficient firm, or perhaps some combination of the two, are worth developing further and we support the ACCC's proposals in this regard. A key benefit of such approaches is that they can be made to be less intrusive and more administratively simple to apply than approaches that rely on a firm's own costs, ideally leading to less micro-management of the firm.

While Origin recognises that approaches which set costs on an external basis may suffer from a degree of uncertainty and lack of appropriate data in the short term, as with the use of ODRC discussed earlier, this can be addressed with providing an appropriate dead band and error correction mechanism around any benchmarked costs. Thus if actual out-turn costs of TNSPs exceed the benchmark by a certain threshold, revenues can be adjusted in the next regulatory period. Ideally however TNSPs should not, to the extent possible, have the expectation that allowable revenues will be set automatically on the basis of their own cost information supplied to the regulator.

For instance, there are a number of ways in which benchmarks could be set, for instance as a cost model describing a hypothetical efficient new entrant, or simply as the average cost of firms in the industry. Regardless, the principle remains the same in that the regulator should be attempting to mimic the interactions of a competitive market. Given that the TNSP gets to either retain or pay out some portion of the difference between the costs they achieve and that of the benchmark (whatever this may be), each competitor attempts to outdo the other in reducing their costs below the benchmark target in order to maximise their revenues. This is exactly what would transpire in a competitive market.

Capital expenditure

Origin also supports benchmarking in relation to capital expenditure, and considers the 5 yearly ODR revaluations as perhaps the best and simplest way of achieving this. This would be preferable to extending the use of the regulatory test to both augmentation and non-augmentation capital expenditure. It is not clear to Origin how the regulatory test provides incentives to reduce capital expenditures over time, in particular given the rather vague guidelines it has in place for distinguishing between reliability investments and investments made on the basis of maximising 'net-market' benefits. It is also unlikely that the proposed inclusion of a 'competition benefits' test would reduce such ambiguity or the potential that currently exists for excessive regulated investment to occur on the basis of poorly defined investment criteria.

Origin also notes that combining a low powered incentive regime; that is, one which relies more on a TNSPs own information and costs with a high powered regime relying more on exogenous variables, may lead to inappropriate substitution between the two. In this respect, the ACCC's intention to apply benchmarking to operational and maintenance expenditures, but roll capital costs into the asset base at cost would appear to be inconsistent.

Benefit sharing

Finally, essential to an appropriate incentive regime for TNSPs is how much of the efficiency gains they get to keep and for how long. Origin supports the use of an RPI-X methodology where consumers receive X (ideally set on basis of external factor such as TFP) and TNSPs get to retain cost saving below X, and considers that a 5 year regulatory period provides an appropriate time period for retainment of such efficiency gains. However, Origin also supports approaches that distribute excess efficiency gains to TNSPs or, conversely, the impacts of inappropriately low benchmarks, fairly between TNSPs and customers where they occur.

Origin also acknowledges the importance of retaining constant incentives over time. Where prices are set largely independent of endogenous costs the effects of periodicity of cost reduction incentives are somewhat less, but the issue of how long the transmission company gets to retain the efficiency gains it achieves must nevertheless still be addressed (that is, incentives for cost reduction are clearly lower at the end of the regulatory period if prices are reduced in line with cost efficiencies immediately the next regulatory period commences).

While the current use of ‘sliding scale’ type mechanisms which phase out cost savings benefits to TNSPs achieved over the previous regulatory period over the following 5 year regulatory period address this issue to some extent, preferable would be for TNSPs to be allowed to retain the efficiency gains achieved in any one year for a full five years (that is, for the same length of time whenever such cost savings are made). Thus, for example, prices could fall every year in proportion to efficiencies achieved 5 years ago. Presumably under such a model TNSPs would have the same incentive to reduce costs regardless of what year of the regulatory period they are in.

A proposal by a consultant to the ACCC to use a PV methodology based on cost outturns in the previous 5 years appears to be a simple and effective method of achieving this outcome.

Conclusion

Origin supports the ACCC views on calculating the cost of capital and establishing pass-through rules for self-insurance and other pass through events. However, Origin does not support removal of ODRC as the primary revaluation methodology for assets. Origin considers that all asset valuation options have serious short comings, but the ODRC methodology both theoretically and practically offers the strongest incentive properties for TNSPs to operate in an efficient manner, while its weaknesses are able to be substantially mitigated through supplementary measures. The key benefit of the ODRC methodology is that it allocates risk to the party best able to manage it, the TNSP.

Another advantage of the ODRC asset valuation methodology is that it does not require a separate incentive regime for capital expenditures and, in terms of the strength of its incentive properties, would be consistent with external benchmarking applied to operational and maintenance expenditure. This would minimise potential substitution effects that would occur if the roll forward methodology for capital expenditure was combined with an external benchmark regime for operational expenditure.

Origin also supports the retainment of a RPI-X type regime (but with X set largely on external factors, such as TFP or efficient costs) but incorporating constant incentives over time in relation to sharing of efficiency benefits.

Please contact Con van Kemenade on 02 9220 6278 if you wish to discuss any of these issues further.



Yours sincerely,

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