Powerlink submission on ACCC's draft decision on Transend's revenue cap

1 Introduction

Powerlink Queensland welcomes the opportunity to make this submission with respect to ACCC's draft decision on Tasmanian Transmission Network Revenue Cap 2004-2008/09.

In this submission, Powerlink does not wish to comment on the specific details of Transend's revenue requirements. The comments are limited to broader issues of regulatory principles that affect TNSP's regulatory environment.

In particular, Powerlink makes the following comments:

- The draft decision continues the disturbing trend of the ACCC lowering the cost of capital to new record low margins above the risk free rate to a level which discourages discretionary investment (interconnectors, alleviation of intra-regional constraints). This may not be an issue in Tasmania, but it is a real issue elsewhere in the NEM.
- The ACCC has made arbitrary cuts to costs, an approach which creates additional regulatory uncertainty and risk for TNSPs.
- The proposed treatment of grid support is unclear, but appears to be a change in direction that gives inconsistent signals with respect to regulatory tests.
- The ACCC's 'alternative approach to capex' requires further work before it should be applied. Powerlink would be happy to participate in any further development of this concept.

2 Cost of capital

The ACCC's estimate for the cost of capital in Transend's draft decision reinforces our concern that the margin between the WACC and the risk free rate is trending down over time, and that this will adversely affect incentives for on-going investment. In the text justifying the value of parameters, the ACCC is indicating both implicitly and explicitly that it believes the current regulatory WACC is conservative and is signalling a further tightening of the WACC parameters in the future. Expectations of even lower future returns makes Australia an unpalatable market for investment in long-term assets. Current world events have further highlighted the value of a secure and reliable electricity supply. In page 46 of the draft decision, the ACCC make the following statement:

> *The ACCC considers that a secure and reliable transmission system is vital to an efficient electricity market. The Productivity Commission has argued that it is better to err on the side of overinvestment in the event of regulatory uncertainty, as the costs of under investment outweigh the costs of overinvestment.*

However, when setting the WACC, the ACCC is sending precisely the opposite signal. In the aftermath of recent major blackouts, it is clear that a regulatory "race to the bottom" is not aligned with the expectations of society and its elected representatives for a reliable power system. Robert Samuelson expressed it like this in the Washington Post:

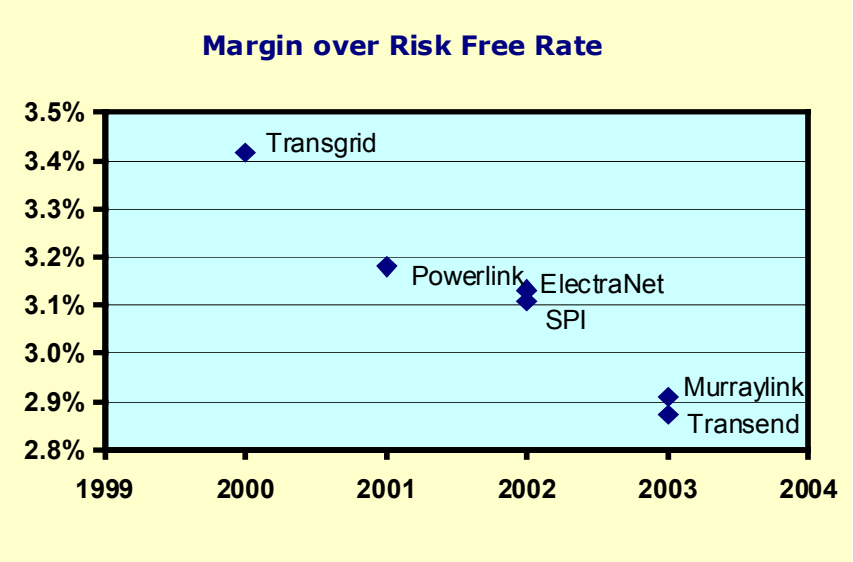
> *"Society's true interest does not involve the lowest possible electricity rate. The public's interest lies in completely reliable electricity produced at reasonable prices. There is a difference."*

2.1 Margin over the risk free rate

The margin over the risk free rate has been decreasing with each transmission revenue cap determination (refer figure 2.1). The margin in this decision (2.8%) is below the level at which one would find it attractive to make discretionary investments (eg interconnectors, alleviation of intra-regional constraints), and whilst this may not be a problem in Tasmania, the signal is one which is felt across the NEM. Academic dissertations on individual WACC elements are a sideshow to the "main game" to the investor's key decision – is the margin above

the risk free rate attractive enough to do the discretionary investments? The answer is now "no".

Figure 2.1. Chart showing the trend of falling margins above the risk free rate



2.2 Debt Raising Costs

Further regulatory uncertainty is created by separating the debt raising costs as an explicit allowance in opex. Powerlink believes the debt raising costs are an intrinsic part of the debt margin and the WACC methodology and should continue to be recovered through the return on capital allowance.

2.3 Debt Margin

The ACCC have determined a benchmark debt margin by examining the credit rating of Australian electricity transmission and distribution companies.

It is a requirement under the National Electricity Code that the debt requirements be set based on benchmarking of *private* enterprises:

Schedule 6.1 of the NEC states in paragraph 1:

> *"Basing target rates of return for public enterprises on the return from alternative private sector investments should result in sound investment and operational*

decisions at the Government enterprise level and balanced investment between the public and private sectors".

Schedule 6.1 of the NEC then goes on to state the principle in more definite terms in paragraph 2.1:

*The weighted average cost of capital is a "forward looking" weighted average cost of debt and equity for a commercial business entity. Accordingly, the Network Owner's weighted average cost of capital will represent the shadow price or social opportunity cost of capital as measured by the rate of return required by investors in a **privately-owned company** with a risk profile similar to that of the network company.*[1]

In clause 6.2.4(c), the NEC puts the obligation on the ACCC:

In setting a separate revenue cap to be applied to each Transmission Network Owner and / or Transmission Network Service provider (as appropriate) in accordance with clause 6.2.4(b), the ACCC must take into account the revenue requirements of each Transmission Network Owner and / or Transmission Network Service Provider (as appropriate) during the regulatory control period, having regard for:

…

*(4) the weighted average cost of capital of the Transmission Network Owner and / or Transmission Network Service provider (as appropriate) applicable to the relevant network service, having regard to the risk adjusted cash flow rate of return required by investors in **commercial enterprises** facing similar business risks to those faced by the Transmission Network Owner and / or Transmission Network Service provider (as appropriate) in the provision of the network service.*[2]

However the list of companies used by the ACCC in the draft determination are primarily Government-owned entities and therefore distort the average credit rating applied to determine the debt margin. Powerlink believes a more diverse range of companies needs to be considered if a debt margin that is comparable with private sector investments is to be established. Our general observation is that 80 basis points set for Transend is too low and not reflective of the market.

[1] Highlighting added
[2] Highlighting added

3 Arbitrary cuts: more regulatory uncertainty

Further adding to the environment of regulatory uncertainty are the arbitrary cuts that the ACCC has applied to Transend's proposed programmes without robust analysis or justification of the decision.

In the conclusions for the capex allowance (page 48), the ACCC states:

> *The ACCC considers that an across-the-board reduction of 10 per cent on GHD's maximum allowance would balance the interests of Transend and its customers more appropriately.*

The choice of 10 per cent appears to be purely arbitrary as no analysis is given. It appears to say that even though ACCC's consultants have performed a detailed investigation of Transend's capex programme (and recommended a substantial reduction) the total figure still seems too high.

Whilst the current adjustment mechanism for capex exists, a cut to the capex allowance is a cash-flow and timing issue *as long as the TNSP is able to demonstrate at the next regulatory review that the overspend was prudent*. However, arbitrary and unsubstantiated decision-making by the regulator increases the regulatory uncertainty creating an environment where the TNSP is unsure that the regulator will accept the case at the next review.

4 Grid support

The draft decision is unclear as to the ACCC's proposed treatment of grid support.

Transend has requested a pass-through mechanism for these costs.

GHD recognises the uncertainty of these costs and recommends the pass-through subject to Transend demonstrating that the costs were the lowest cost option.

The ACCC has set a (preliminary) fixed allowance of $2M pending further details of discussions between Transend and the grid support service provider. However, the draft decision provides no details on the intended treatment of the allowance.

Grid support costs are payments related to the use of local generation or load management instead of capital investment in the transmission network. Whilst grid support is also used to facilitate maintenance work, the most significant use of grid support arises when it is the lowest cost solution to a network limitation under the regulatory test.

As regards forecasts of grid support for inclusion in the revenue during regulatory reviews, they can only be an estimate and even more uncertain than capex.

Because the drivers are predominantly the same, the *need* for grid support is therefore subject to the same uncertainties as the *need* for capex. It is because of this uncertainty that capex forecasts are scenario-based (probabilistic).

Even where the need for either grid support or capex has been determined, until a full investigation of all the options during the regulatory test process, it is impossible to predict *which* network limitations are best addressed through grid support.

Further, grid support costs typically have a large variable cost component. Consequently, they are many times more volatile than network capex. Hence, even in the cases where it is expected that grid support will be 'winning' option, the actual costs are subject to high levels of uncertainty.

Powerlink contends that grid support should continue to be treated as a pass-through. The ACCC can apply the same justifications that it applied in the Powerlink determination ,under which Powerlink has to demonstrate that the pass-through is material, reasonable and efficient.

If grid supports costs were no longer treated as a pass-through, TNSPs would, in comparing options in the regulatory test, have to factor in the volatility of grid support costs by adding in a 'contingency amount' to the *statistical mean* (or expected) grid support costs when evaluated against network capex. Such an approach would be commercially sound and justifiable, but would also result in the grid support option being less favourable in the economic evaluation.

5 Alternative capex approach

In Appendix C, the ACCC have proposed an alternative approach to capex which provides for two streams: one treated according to the usual treatment that has been applied in previous revenue cap determinations and another stream that would be treated in a more light-handed manner.

Powerlink supports the introduction of more light-handed mechanisms in regulation, particularly where the TNSP is able to reach agreement with customers. However, Powerlink's initial view is that the proposed approach confuses the NEC processes of regulated revenue setting (which is concerned with what is a prescribed and an excluded service) and the process of allocating "who pays" for the service. This needs to be further worked before it should be applied.

Powerlink would be happy to participate in any further development of this concept.