Powerlink's Comments on the ACCC's draft decision on TransGrid's Revenue Cap

JULY 2004

Introduction

Powerlink welcomes this opportunity to comment on the ACCC's Draft Decision "NSW and ACT Transmission Network Revenue Caps – TransGrid 2004/05-2008/09" dated 28 April 2004.

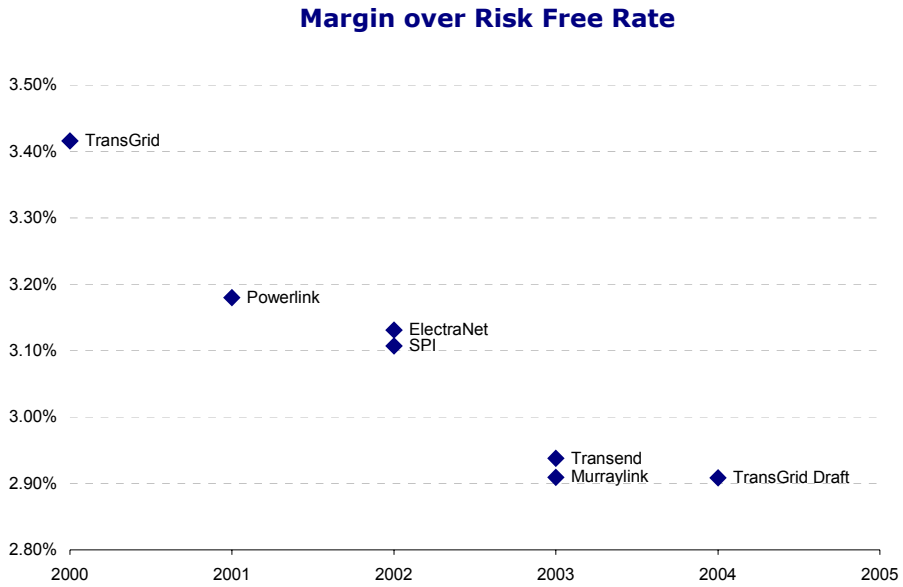
In this response, Powerlink limits its comments to significant matters of regulatory principles as they have been applied in the Draft Decision and that, in our view, have a detrimental effect on the stability and certainty of the regulatory environment for TNSPs. In particular:

- The rate of return allowed is too low to encourage discretionary investment
- Arbitrary cuts in the opex are at odds with service standards objectives
- A growing asset base will increase operating costs

Powerlink and other TNSPs also expressed these views during the public forum held in Sydney on 18 June 2004.

Rate of return

Over the last few regulatory decisions, much discussion has been had on the parameters that make up the allowed rate of return. However, it needs to be recognised that, ultimately, what matters to investors is the margin above the risk-free rate. The following chart shows how this margin has been dropping over time:



As the policy setting body in the National Electricity Market (NEM), the Ministerial Council on Energy (MCE) has explicitly recognised the value of a strong transmission system interconnecting the States.

Much effort has been given to providing incentives for TNSPs to manage the market impact of network outages. While Powerlink supports this work, we have observed that over 2004 QNI has hit its maximum limit during times when all the network is in service many more times than it has been constrained due to a network outage. The most effective way to reduce market impacts of interconnector constraints is by increasing the maximum capability.

However, in contrast with transmission augmentations that ensure reliability (which are mandatory), investment in interconnectors is discretionary. As such, it needs to compete for funds with alternative investments. In order for interconnectors to be favoured, their returns need to be competitive compared with returns in alternative investments. The rate of return in the Draft Decision does not deliver this.

The test is how the margin above the risk free rate stacks up against competing investments of a similar risk profile for the funds and the consequences of setting the WACC margin at these low levels needs to be considered.

Service Standards and opex

Another place where the broader implications needs to be considered is in the area of the opex cuts in the Draft Decision with reference to their impact on service standards.

The Draft Decision contains important implications when the ACCC disallows overtime work and reduces the level of opex allowed.

TNSPs can minimise the market impact of network outages by a variety of techniques. Amongst them are doing more work "live" and scheduling outages at non-peak times. Both of these techniques imply higher costs and overtime.

The market benefits are clear and can be very significant. For example, during the public forum of 18 June 2004, it was reported that the difference between an outage during peak times and an outage during non-peak times could be 50c/MWh in pool price terms which is millions of dollars. However, the extra overtime costs are only tens of thousands of dollars. The economic test here is clear.

For regulatory consistency, when introducing service standards aimed at reducing the impact of network outages on the market, the ACCC must allow the consequential higher opex needed to deliver the desired outcomes.

In any case, the ACCC needs to consider the broader consequences on service standards of disallowing these more expensive practices, such as live work and overtime.

Opex and growth in asset base

In the Draft Decision, the ACCC has excluded increases in opex due to growth in the number of assets that need to be maintained.

It is clear that if the number of assets increases (eg. more kilometres of line or more assets in substations), costs associated with maintaining them will increase. This should not be surprising and needs to be recognised. *The only question is the quantum and the effect of economies of scale*.

On page 30, the ACCC includes some suggestions of why costs do not increase with growth in assets. These are not supported by quantified analysis and in fact they rely on very simplistic and misplaced notions.

One of the suggestions is that investment in IT will reduce costs. IT investment is mostly about ensuring that systems are supportable as software changes, to keep up with increased obligations and about increased "service level". In Powerlink's case for example:

- An outage management system to minimise customer and market impact of outages;
- Environmental management systems are required to meet today's higher environmental standards; and

- A safety management system was adopted to comply with the new Electrical Safety Act.

There is also a suggestion that new technology will have lower opex costs in the early years. Our experience is quite the opposite: new technologies have major teething problems and high rates of "infant mortality".

Finally, there is a suggestion that replacing aged assets will decrease costs. This will only be the case if asset replacement causes a *material and sustained* reduction in the average age of assets.

On page 29, the ACCC admit that *"the ACCC has not analysed the relationship between opex and capex in TransGrid in detail."*

However, on page 30, the ACCC states:

> *"...the ACCC considers that it is reasonable to suggest that any increase in operating and maintenance costs that may arise because TransGrid has a longer length of line or cable to maintain, will be more than offset by decreases in opex attributable to the above factors.*"

What it is saying is that increasing the asset base by over 34% will not increase costs. In fact, the ACCC is imposing a mandatory reduction in costs. And all of this based on misplaced notions of cost reductions associated with capex.

The ACCC may believe that the model originally proposed by TransGrid does not adequately account for economies of scale. The solution, however, is not to adopt a model that assumes that capex will allow operating costs to reduce despite a 34% increase in assets – only based on very broad and misplaced notions.