



Hon. Paul Lucas MP



Queensland
Government

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Our Reference: MIN45204.03

Minister for
Innovation and Information
Economy

12 JAN 2004

Mr S Roberts
General Manager
Regulatory Affairs – Electricity
Australian Competition and Consumer Commission
PO Box 1199
DICKSON ACT 2606

Dear Mr Roberts

**Re: Review of the Draft Statement of Principles for the Regulation of
Transmission Revenues**

Thank you for the opportunity to make a submission to the Australian Competition and Consumer Commission's discussion paper 'Review of the Draft Statement of Principles for the Regulation of Transmission Revenues'.

Please find enclosed a submission from the Queensland Government's Office of Energy.

Yours sincerely

PAUL LUCAS MP
Minister for Innovation
and Information Economy
Minister with responsibility for Energy

Encl.

Review of the Draft Statement of Principles for the Regulation of Transmission Revenues

The objective of the National Electricity Market (NEM) is to provide consumers and industry with competitively priced and reliable electricity to underpin Australia's economic and social development. Transmission plays a central role in delivering on this objective.

Within the electricity supply chain, transmission accounts for less than 10% of the total cost of delivered electricity. However, inadequate levels of transmission can result in volatility in wholesale prices due to inadequate competition between generators and a lack of interconnection between regions, potentially resulting in higher electricity prices to consumers.

Indeed, the recent experience of high and volatile wholesale prices in South Australia provides an example of the way in which inadequate transmission investment can contribute to higher end use prices. South Australian customers have been faced with average price increases of over 25% (an average of \$240) since 1 January 2003 - a lack of interconnection contributing in no small part to these price outcomes.

For Queensland, transmission is particularly important. Queensland has the highest load growth in the NEM, estimated to average 3.2% per year over the next 10 years, compared with less than 2% for the majority of the other States. Notably, peak electricity demand is expected to grow by 6% in south east Queensland over the next three years.

Queensland also has the most dispersed and geographically diverse network in Australia. Queensland has a long thin network with baseload generation located predominantly in the south and central areas due to efficient access to high quality coal. As a consequence however, the main power flows from central Queensland must travel significantly further to the main load centre than is the case in other States. By way of example, flows from central Queensland to Brisbane travel three times farther than flows from the Latrobe Valley in Victoria to Melbourne.

Queensland's dispersed grid, a booming population and significant industrial development has created a corresponding need for higher levels of transmission investment. Since the NEM's inception, over \$1 billion has been invested in transmission assets in Queensland – representing approximately one-third of total NEM expenditure.

These factors combine to make timely and efficient investment in transmission a key priority for the Queensland Government.

Framework for Transmission Development

It is important to understand the role of transmission in the NEM when considering the optimal framework for transmission development. Queensland is of the view that transmission is fundamentally a transportation system for delivering electricity from a generation source to load centres. It has an essential role in ensuring the security and reliability of the electricity system as well as facilitating generator on generator competition.

Queensland is of the view that in respect of 'reliability' investment, the current arrangements are working well. Transmission investment in the NEM has been delivering the level of supply reliability that consumers and a modern industrial economy require.

It is acknowledged however that there have been some sub-optimal outcomes in respect of market investments, particularly investment in interconnectors and those required to alleviate intra-regional constraints. Investments of this kind can deliver significant benefits. For example, a study commissioned by The Council of Australian Government's Energy Market Review found that a 20% increase in interconnector capacity throughout the NEM would provide benefits with a net present value of around A\$1.1 billion over the period from 2005 to 2010.

In Queensland's own experience, since the Queensland - New South Wales Interconnect (QNI) and additional generation have been commissioned, Queensland power prices have reduced and price volatility has substantially diminished. Indeed, Queensland's pool prices fell by 38% in the first six months after commissioning of QNI from the corresponding six months a year earlier.

From a Queensland perspective the optimal framework for transmission investment allows for:

- achievement of economic efficiency – low cost to consumers;
- timely investment; and
- avoidance of inefficient regional price differences.

The Queensland Government recognises that a holistic approach must be taken to ensure these objectives are achieved. This is why Queensland supports a range of measures which combined, will facilitate timely and economic investment in transmission. These include:

- changes to the regulatory test to recognise competition benefits;
- the publishing of a single national transmission planning document to make network information more transparent and accessible to the market;
- the development of a **last** resort mechanism to ensure that economically justified inter-regional investments proceed; and
- removal of existing biases towards unregulated interconnects.

The ACCC in its role in regulating transmission revenue plays an important part in the framework for transmission development. The approach adopted by the ACCC in undertaking this role, as set out in the Draft Regulatory Principles, influences TNSP decision making in respect of investments and consequently, facilitates future transmission development.

Revaluation of the asset base versus roll-forward

Each option proposed by the ACCC for determining the asset base for future reviews has advantages and disadvantages. The periodic revaluation method ensures, in theory, that regulated tariffs are set consistent with competitive market outcomes. However, periodic revaluation introduces a level of uncertainty into the TNSP's business which is likely to negatively impact upon future investment.

The lock-in option avoids this risk to investment. However it is acknowledged that if there were errors in setting the jurisdictional asset base, these errors would be carried forward into the following regulatory periods.

In 1999, the former Queensland Electricity Reform Unit (QERU) engaged independent consultants, including engineering consultants, to undertake a valuation of Powerlink's network assets in Queensland. The valuation was calculated using a Depreciated Optimised Replacement Cost (DORC) methodology and applied the ACCC's Draft Regulatory Principles. Importantly, QERU recognised that the exercise was part of the transition of regulatory responsibility from the jurisdiction to the ACCC and was mindful to provide a valuation which minimised the risks of price shocks to consumers when the role of economic regulation was transferred.

The Office of Energy is confident that the process undertaken to determine the asset value was robust and the amount set by the jurisdictional regulator for the asset base was appropriate.

In recognition of the importance of creating a regulatory regime which encourages investment in transmission and given the robust procedure undertaken to determine the asset base, the Office of Energy supports the ACCC's view to consider each revenue cap on a case by case basis but with the preferred position to 'lock-in' the asset base in the absence of evidence to suggest an underlying problem with the jurisdictional valuation.

Rate of Return

Clause 6.2.2 of the National Electricity Code requires the ACCC to create a regulatory regime which balances a number of factors. Importantly, a balance must be reached between preventing monopoly rent extraction by TNSPs on one hand and providing a sustainable commercial revenue stream and fostering an efficient level of investment on the other.

The ACCC's discussion paper addresses a number of component parts of the rate of return including the equity beta and the risk-free rate. The ACCC's proposal to move to more market-based measures in determining Weighted Average Cost of Capital parameters is reasonable, as it will be set relative to other asset classes allowing for greater transparency. Accepted corporate finance practise should ensure returns to regulated entities relatively correspond to other investments according to their risk/return relationships. However, there are some issues that will need to be dealt with cautiously when using market-based measures:

- the proxy equity beta for an unlisted company is calculated with a large degree of subjectivity, which can have a significant impact on the rate of return; and
- having selected a suitable basket of comparable companies to calculate an equity beta, the period and number of observations needs to be carefully selected to ensure that it represents the medium to long term view.

In addition, it is important not to deviate from standard practise on such matters as the proxy measure of the risk-free rate. The longest-dated liquid Commonwealth bond is used because it is considered to be the closest proxy for a risk-free investment whose time horizon is consistent with long-lived assets.

The Office of Energy is of the view that it is also important to consider the combined effect of the various components and whether as a whole they represent a fair and reasonable rate of return.

There has been considerable debate recently regarding the adequacy of rates of return on regulated utilities in Australia. It is clear from this debate that a careful examination of rates will have to be undertaken to ensure they are fair and reasonable.

A fair and reasonable rate of return should provide the right incentives for adequate, efficient and timely investment. As identified above, this is particularly important in respect of market investments such as interconnectors and the alleviation of intra-regional constraints, given the significant benefits and efficiencies they can deliver.

In summary, the Office of Energy encourages the ACCC to bear in mind in reviewing the Draft Statement of Principles, the broad objective of creating a framework for transmission development which facilitates efficient and timely investment. Only adequate and timely investment in transmission will ensure secure and reliable supply and importantly, facilitate the delivery of reliable and competitively priced electricity to consumers.