TXU's submission to Intelligent Energy System's (IES) Review of the Interregional Market Benefits of DirectLink

1 Introduction

TXU has some concerns regarding a MNSP's right to convert to a prescribed service as established by the precedent set in the Murray link case, because it creates quite ambiguous outcomes in some critical parts of the conversion. The ACCC promulgates the regulatory test in accordance with section 5.6.5 A of the Code. An option satisfies the regulatory test in the second leg of the test if it "*maximises the NPV of the market benefit compared with a number of alternative options in a majority of reasonable scenarios.* " This process implies that a proponent of the regulatory test undertakes this exercise in a vigorous manner before determining the most appropriate option in accordance with the test itself.

Applying the regulatory test to an asset that has already been built leads to ambiguous outcomes. For example, does the option chosen that satisfies the regulatory test, lead to an asset valuation for the joint venture consistent with DORC valuation in chapter 6 of the Code? Or, does the value of the option that satisfies the regulatory test reflect the economic value of the joint venture asset itself?

These are some of the outcomes that arise from applying the regulatory test to an asset after an asset has been built. Whilst the ACCC has resolved and addressed some of these issues in the MurrayLink case, there is still some debate regarding the credibility of the outcomes of this process.

2 TXU Position

TXU position on the IES review of the Interregional market benefits that arise from the Direct-Link joint venture is that it has concerns regarding the following issues.

Let me outline these five issues.

1. The reg test is applied to ensure competitive neutrality and efficiency between market based investments and regulated investments. This objective will only be met if project proponents claims are are restricted to the allowable benefits as prescribed in the regulatory test. In light of this, it supports IES's comments regarding the modelling assumptions that have been made in claiming the interregional benefits specifically as they apply to the amount of the benefits claimed.

2. TXU believes that there should be a strong 'onus of proof' of the proponent of the project in question to satisfy all aspects of the assessment of the regulatory test given the material impact that network investments can have on the economic value of market based investments in the supply chain and on final electricity prices to users.

3. TXU supports an independent evaluation of the application of the regulatory test in accordance with its original submission in the " *Review of the Regulatory test for network Augmentations" 11 Aug 2004.*

4. TXU believes there is a need for a stable regulatory test to ensure that it achieves its objectives and encourage a more stable regulatory framework. As such, it supports the ACCC's position to draw on the regulatory precedents already established in determining the outcome of this process.

5. It has concerns regarding the discount rates applied to the *market development scenario* analysis as applied by the joint venture.

3 The regulatory test is applied to ensure competitively neutrality and efficiency between market based investments and regulated investments. This objective will only be met if project proponents claims are restricted to the allowable benefits as prescribed in the regulatory test. In light of this, it supports IES's comments regarding the modelling assumptions that have been made in claiming the interregional benefits specifically as they apply to the amount of the benefits claimed.

TXU believes the regulatory test's objective of competitive neutrality and efficiency will only be achieved if the inter-regional benefits claimed by Direct-Link are consistent with the prescriptive benefits claimable under the regulatory test. TXU believes that the regulatory test is too easily manipulated by project proponents in terms of selection of projects, market input assumptions, market scenarios etc. The test is extremely judgemental and therefore the outcome of the assessment for any given project proponent might not be readily predictable. This creates undue risk for proponents of alternative projects and market-based investments.

As such TXU welcomes the ACCC's exercise of critiquing the value of the inter-regional benefits that have been claimed by the Direct-Link Joint Venture on the basis that regulatory test has not been applied in accordance with Sect. 5.6.5(a) of the Code. TXU support the ACCC's on the following issues;

- The review of the modelling assumptions that reduce the benefits to Direct-Link if the projects do not provide any northward flow.
- The review of the modelling assumptions that change inflated the unrealistic spot price out turns given that they would significantly impact the dynamics of new entry generation and associated benefits that inflate the interregional benefits.
- The review of the modelling assumptions that use un-supported assumptions on new entry costs that inflate the inter- regional benefits.

4 TXU believes that there should be a strong 'onus of proof' of the proponent of the project in question to satisfy all aspects of the assessment of the regulatory test given the material impact that network investments can have on the economic value of market based investments in the supply chain and on final electricity prices to users.

TXU believes that a strong 'onus of proof' on demonstrating that the regulatory test has been applied as intended under Sect. 5.6.5(a) under the Code should lie with the proponent of a project. The project can only be guaranteed to provide a market benefit under these circumstances. As such,

- The approval of an investment should provide a clear demonstration by the proponent that the investment provides a benefit to the "market", that is, it satisfies the NPV of the market benefit. As such, TXU's supports the ACCC's current critique that subtracts market benefits derived under different scenarios for all options where there is clearly no benefit to the market.
- There should be a high degree of transparency regarding the application of the reg test with ample opportunity for all stakeholders to scrutinise it. As such, this provides a level of scrutiny that ensures the regulatory test has been applied as it was intended.

Clearly there is an incentive for any proponent to claim high benefits therefore they must be robustly demonstrated and tested.

5 TXU supports an independent evaluation of the application of the regulatory test in accordance with its original submission in the " *Review of the Regulatory test for network Augmentations" 11 Aug 2004.*

TXU submission to the ACCC consultation on the " Review of the regulatory test for network augmentations" emphasized the importance of having an independent assessment of the regulatory test applied by TNSPs to network augmentation. TXU specifically requested that large investments (> $20M) should be excluded form the ex-ante revenue cap and subject to an independent regulatory test on the basis that these investments were most likely to have an impact on market based investments.

TXU supports the ACCC's approach to independently evaluate the application of the regulatory test (including the inter regional benefits) given the test is too easily manipulated by project proponents in terms of selection of alternative projects, market input assumptions, market scenarios, assumed residual values etc. As such, it welcomes the adjustments to the modelling assumptions in this case.

TXU acknowledges that an independent assessment of the regulatory test on an MNSP converting to a prescribed service is a compulsory exercise in determining the investment option that maximises the value to the market. However, even though the reg test is applied after the MNSP has been built, it supports the precedent established by the ACCC to independently audit the reg test as applied by Direct-Link. Furthermore, it supports the application of this principle (as put forward in tis submission to the regulatory test consultation) that an independent evaluation of all assets over 20M value that will have an impact on market outcomes be supported. It is only in this environment that one is able to guarantee that the regulatory test has been applied to ensure competitive neutrality and efficiency.

6 TXU believes there is a need for a stable regulatory test to ensure that it achieves its objectives and encourage a more stable regulatory framework. As such, it supports the ACCC's position to draw on the regulatory precedents already established in determining the outcome of this process.

TXU has highlighted its concerns earlier in this submission that it believes the regulatory test is easily manipulated by project proponents in terms of selection of projects, market input assumptions, market scenarios assumed residual asset values etc. This fact combined with a very thin body of regulatory precedent from which to draw established principles in applying the regulatory test creates uncertainty. As such , TXU supports reg test applied by the ACCC that relies on the precedent set

1. By the Victorian Supreme Court in the SNI appeal.
2. The Murray-Link case

TXU notes that the ACCC relies heavily on the regulatory precedent applied in Murray-Link to establish if Direct-Link has applied the regulatory test in accordance with the Code. TXU supports the methodology applied by the ACCC in this instance.

7 TXU has concerns regarding the discount rates applied to the '*market development scenario*' analysis as applied by the joint venture.

TXU notes that the Direct-Link joint venture applies an economic discount rate to its various scenarios in applying the regulatory test at 7%, 9%, & 11%. TXU believes that the discount rates applied in Direct-Link's "what if" scenario analysis reflect unrealistic discount rates. The revenues applied under the scenario analysis applied by Direct-Link have not been discounted at high enough rates to reflect a commercial discount rate commensurate with the merchant risk in the NEM. As such, the discount rate applied to the revenue stream is too low, which leads to unreliable outcomes in the present value calculations in the market benefit analysis. TXU believes that a post tax real WACC of around 14% (with an implied 60;40 gearing ratio) better reflects the risk of merchant generation.

TXU notes the ACCC has accepted this principal in the debate in the ACCC's review of the regulatory test. On p48 of the review of the regulatory test – Final Decision its states

" The ACCC considers that the discount rate adopted for the purposes of the regulatory test evaluation should be a commercial discount rate adopted for the purposes of a regulatory test evaluation in order to ensure network and non network investments are compared on a competitively neutral basis. The discount rate used in an assessment should be consistent with the opportunity cost of capital of an investment in electricity infrastructure. The ACCC believes that the regulatory WACC might reasonably be considered to be the lower boundary of the discount rate but not the mean value around which the sensitivity testing is conducted."

Section 10 of the regulatory test simply states
" The present value calculations must use a commercial discount rate appropriate for the analysis of private investment in the electricity sector. The discount rate used should be consistent with the cash flows been discounted"

TXU believes a pre-tax WACC of around 14% better reflects the commercial risks commensurate with merchant risk in the NEM. This discount rate should be applied to the scenario analysis applied by Direct Link in determining the market benefit.

8 Conclusions

So, in summary, the five key issues that TXU has regarding the modelling of the inter regional benefits for Direct Link include;

1. The reg test is applied to ensure competitively neutrality and efficiency between market based investments and regulated investments. This objective will only be met if project proponents claims are restricted to the allowable benefits as prescribed in the regulatory test. In light of this, it supports IES's comments regarding the modelling assumptions that have been made in claiming the interregional benefits specifically as they apply to the amount of the benefits claimed.

2. TXU believes that there should be a strong 'onus of proof' of the proponent of the project in question to satisfy all aspects of the assessment of the regulatory test given the material impact that network investments can have on the economic value of market based investments in the supply chain and on final electricity prices to users.

3. TXU supports an independent evaluation of the application of the regulatory test in accordance with its original submission in the " *Review of the Regulatory test for network Augmentations" 11 Aug 2004.*

4. TXU believes there is a need for a stable regulatory test to ensure that it achieves its objectives and encourage a more stable regulatory framework. As such, it supports the ACCC's position to draw on the regulatory precedents already established in determining the outcome of this process.

5. It has concerns regarding the discount rates applied to the *market development scenario* analysis as applied by the joint venture.

TXU hopes that the ACCC will take these comments into consideration before making a determination on the market benefits derived by Direct Link. Contributing to the debate in an open and transparent manner ensures that the regulatory precedent set in these crucial issues evolves in a satisfactory manner.

Yours Sincerely

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