TXU RESPONSE TO THE AUSTRALIAN CONSUMER & COMPETITION COMMISSION

REVIEW OF DRAFT REGULATORY PRINCIPLES

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1 Executive Summary

TXU believes the long-term impact of regulatory error and uncertainty in relation to energy infrastructure is to deter both network and market-based investment. Indeed, regulatory discretion under the legislative instruments that apply to gas and electricity transmission networks creates uncertainty and risk. Whilst TXU acknowledges that not all regulatory arrangements can be determined up-front in a regulatory process, it supports the objectives of reducing regulatory uncertainty, which underpins the Australian Competition and Consumer Commission's (ACCC) draft regulatory principles (DRP).

In general, TXU considers that a regulatory regime that provides incentives for cost minimisation for the Transmission Network Service Providers (TNSP's) is likely to ensure that expenditure incurred is efficient. TXU recommends that the DRP should aim to provide an appropriate balance between incentives to invest and the application of expenditure reviews as proposed by the ACCC in relation to an assessment of the regulatory-test conducted by a TNSP during the regulatory period.

The combination of the existing regulatory-test requirements and the potential for the ACCC to review past expenditure at a price reset should ensure that TNSP's investment during a regulatory period is efficient. However, TXU believes that in some limited circumstances such as where a TNSP plans to undertake a significant augmentation investment during a regulatory period, an independent ex-ante review by the ACCC of this expenditure may be appropriate.

TXU considers the following overarching objectives should be reflected in any regulatory regime:

- The regime should permit market-based investments to develop prior to the imposition of regulated solutions;
- There be sufficient <u>long-term</u> incentives to invest <u>efficiently</u> in long-lived sunk assets (such as gas and electricity networks);
- There be a high level of regulatory certainty for efficient investments to enable prediction of revenue streams for investors and reduce regulatory risk; and
- The regulatory regime should be transparent and treat all regulated businesses equitably in relation to the specific circumstances of the business.

To achieve these objectives TXU's position on the DRP is to support the following key policy positions.

- The regulatory regime should provide incentives for efficient long-term investment thereby allowing the ACCC to adopt a 'light-handed' approach to assessing the efficiency of actual expenditure;
- TXU supports the ACCC's preliminary view of 'locking in' TNSP asset values, provided there is no evidence of significant deficiencies with the original jurisdictional asset values. In relation to new capital expenditure, the combination of the requirements specified in the regulatory-test and the threat of a re-optimisation should provide adequate incentives to ensure expenditure is efficient.
- In circumstances where a TNSP plans to undertake a significant investment (ie, a threshold value of greater than $20 million), TXU recommends a mandatory review by the ACCC of the regulatory-test as applied by the TNSP, *before* the network investment is undertaken. However, for smaller investments below this threshold, TXU recommends that the ACCC should not conduct a review/audit of the application of the regulatory test;

- The ACCC should in the DRP give effect to the Productivity ACCC conclusions in relation to cost of capital determinations;
- Incentive arrangements for achieving efficiencies on capital expenditure could be strengthened further by the introduction of an incentive mechanism on capital;
- The ACCC should adopt a long-term incentive arrangement that recognises that over time efficiency improvements are more difficult to achieve and are subject to diminishing returns to ensure continuous incentives for TNSP’s to seek efficiencies; and
- The ACCC should move to greater use of external benchmarks to determine operating and capital costs, provided that these benchmarks take into account the specific circumstances of each business (eg. changes to business scope and operating environment).

The application of the above policies would reduce the need for an ACCC review of regulatory-tests and ex-post reviews of expenditure.

2 Specific Comments

2.1 Re-valuation of the asset base versus the merits of roll-forward

TXU supports the ACCC's preferred position to "lock-in" the asset base on the basis it avoids some of the subjectivity associated with DORC re-valuations. It agrees that 'subjective' decisions about the value of replacement costs, depreciation schedules, estimates of useful life, engineering criteria and asset aggregation, amongst other variables will impact on the Depreciated Optimised Replacement Cost valuation.

TXU acknowledges the ACCC has the discretion to revalue the regulatory asset base under Section 6.2.3 (d)(4)(iv) of the **National Electricity Code** ('the Code'). This should act, as a strong incentive for TNSP's to diligently apply the regulatory-test to proposed augmentations to ensure the regulatory option chosen provides a net market benefit or is the least-cost network solution to meet reliability obligations. In most cases, the threat of a revaluation is likely to ensure that the regulatory option chosen should achieve competitive neutrality between market and non-market investments and economic efficiency (or the maximum 'market benefit').

TXU believes that easements should be valued at the cost of acquiring the easement indexed for changes in inflation. There are a number of advantages to this approach. These include:

- The indexed historical cost approach to the valuation for easements can be readily identified as records of purchased easements enable the amount paid, to be objectively verified. As such, this approach avoids the uncertainty and subjectivity associated with determining current asset values;

- It provides compensation to the owner of the easements by providing a rate of return on the investment. A return on the indexed historic cost valuation will maintain the value of the firm's financial capital thereby enabling the recovery of investments; and

- It is simple to administer and valuations are comparable across assets.

2.2 Capital Expenditure

It has been TXU's consistent policy that a national transmission planner, independent of ownership, should be responsible for the overall system planning of large transmission augmentations in the National Electricity Market. Such a body could perform cost-benefit assessments on proposed network augmentations to ensure assessments are undertaken in an impartial manner. In the absence of such a body, the regulatory-test will necessarily remain the principle source of confidence for customers and market investors that efficient investment is occurring.

In general, TXU believes that the existing incentive based regulatory regime, which provides rewards for under-spending and penalties for over-spending during a regulatory period, combined with an efficiency roll-over mechanism and the application of the regulatory-test should ensure that expenditure incurred by a TNSP is efficient, consistent with the objectives of the **Code**.

TXU considers that the capital allowances provided by the ACCC, as part of a price reset should reflect a reasonable forecast of market developments and demand over the next five years. To the extent that circumstances change over time during the regulatory period, where more efficient augmentation options can be identified (including market solutions), this should be assessed by the application of the regulatory-test.

However, TXU recommends that the ACCC adopt the following approach in relation to the regulatory-test:

- For small augmentation investments (ie. for investments less than $20 million), the ACCC should not review the application of the regulatory-test as applied by a TNSP;

- For large augmentation investments (investments greater than $20 million), TXU recommends a mandatory review of the regulatory-test by the ACCC with public consultation, *before* the investment takes place.

TXU does not support a review of the regulatory-test by the ACCC for investments involving small augmentations as these investments are unlikely to impact the development of market-based augmentation solutions and the costs of a second review (expenditure has already been reviewed as part of the price reset) are likely to outweigh the benefits.

In relation to large investments, an independent review of the application of the regulatory-test by the ACCC should minimise any potential by a TNSP to bias investment decisions in favour of regulated solutions compared to a market-based solutions. Therefore we believe a mandatory review of the regulatory-test for large investments by the ACCC *before* the investment occurs would be better than the ACCC's proposed approach of applying an ex-post audit review of the regulatory-test.

TXU considers that an ex-ante review should include public consultation, permitting parties who suspect a bias to present such evidence to an independent reviewer.

An important feature of the regulatory-test that needs to be maintained is the limitation on the test horizon of future investments to avoid regulating investments pre-empting market investments. As commercial investors will necessarily wait to the last minute before committing funds, a regulatory-test should not be conducted on a large investment more than 12-18 months in advance of its construction. This provides an opportunity for generation or demand-side solutions-to develop, prior to the consideration of regulated solutions.

In the event that the ACCC adopts an ex-post review of expenditure undertaken by the TNSP, TXU recommends that any review, will need to ensure that this assessment is based on the same information that was available at the time the investment decision was undertaken by the TNSP. Moreover, the ACCC will need to release comprehensive Guidelines as to how an assessment of the regulatory-test would be undertaken.

The introduction of an incentive carry-over mechanism on capital expenditure should enable the ACCC to adopt a less intrusive approach in relation to rolling in actual capital expenditure incurred during the regulatory period.

TXU proposes that an incentive carry-over mechanism on capital expenditure that considers the difference between the forecast capital allowance approved in the previous revenue cap decision with out-turn expenditure, (adjusting for any scope changes beyond the control of the business) be introduced to strengthen incentives for a TNSP to operate efficiently over a regulatory period. Under this mechanism, the TNSP would share the efficiency gains with customers over a period of time.

2.3 Incentive Mechanism and Benefit Sharing

TXU's distribution network is subject to price cap over a five-year regulatory period. This provides incentives for TXU to reduce costs as this out-performance is retained during the regulatory period. In addition, these incentive arrangements are strengthened by the inclusion of an efficiency carry-over mechanism, which allows any out-performance to be retained for five years and provides constant incentives to seek efficiencies over the regulatory period.

TXU considers that the incentive regime under the existing building block approach could be improved as applied by the ACCC and Jurisdictional Regulators. In particular, TXU considers that the incentive arrangements outlined above could be strengthened further by:

- External benchmarking or less reliance on the actual costs of the business; and
- Modifications to an efficiency carry-over mechanism to recognise that over time efficiency improvements are more difficult to achieve.

2.1.1 *External Benchmarking*

TXU supports the ACCC's preferred position in relation to exploring the scope to adopt greater reliance on external costs to set revenues and prices. TXU agrees with the ACCC that the use of external costs will improve incentives to reduce costs by further breaking the nexus between revenues and the actual costs of the business.

However, TXU is mindful that exogenous cost measures will still need to be adjusted to take into account the specific circumstances of each business. In deriving these benchmarks, the ACCC should recognise and take into account differences in operating environments and anticipated differences in demand growth between the businesses.

The use of external benchmarks in setting prices and revenues should enable the ACCC to adopt a light handed approach in terms of reducing any tendency to conduct an ex-post review of the efficiency of a TNSP's actual expenditure.

TXU believes that the required or risk adjusted cost of capital should reflect a greater reliance on 'higher powered' incentive regimes which rely to a greater extent on external benchmarks. TXU recommends that a factor, which reflects this incremental risk, should be applied to the return on equity component of the required rate of return.

2.1.2 *Benefit Sharing Mechanism*

The inclusion of a benefit sharing mechanism (such as the rolling mechanism as adopted by the Essential Services Commission in Victoria) in setting revenues would strengthen the existing incentive arrangements and provide continuous incentives to seek efficiencies over the regulatory period.

TXU recommends that any benefit sharing arrangements should apply to both operating and capital expenditure to minimise any incentives to substitute capital expenditure for operating expenditure and vice versa.

It is important for the ACCC to design a long-term incentive arrangement that recognises that over time efficiency improvements (eg, innovation) are more difficult to achieve and are subject to diminishing returns.

TXU recommends that the ACCC adopt similar arrangements as proposed by the Water Regulator in the United Kingdom. The Water Regulator has proposed a multiplier to any efficiency gains achieved by a 'frontier' business, which recognises that stronger incentives need to be applied over time to ensure cost reductions.[1]

[1] Ofwat: A further consultation on incentive mechanisms - Rewarding future out-performance and handling under-performance of regulatory expectations, June 2003.

2.4 Self-Insurance and Pass Through Events

2.1.3 *Insurance*

TXU has some concerns that the ACCC's proposed regulatory treatment in relation to insurance costs has the potential to discriminate between external insurance and self-insurance. In particular, the ACCC has indicated that a number of matters, including a review by an insurance consultant, need to be satisfied prior to considering a self-insurance application.

TXU believes that this process may discriminate in favour of external insurance by network operators, even in cases where self-insurance may be more efficient. As a result, in some cases customers may incur higher costs in network charges, where regulatory arrangements distort incentives between insurance and self-insurance practices.

2.1.4 *Pass-Through Events*

TXU agrees with the ACCC that pass through events should be clearly identified in advance and cover events clearly beyond the control of the network operator. TXU considers that the following events should be included as pass through events:

- Changes in Government taxes and fees;
- Changes in mandatory technical Regulations, Codes, Guidelines and Acts.

The Independent Pricing and Regulatory Tribunal appears to accept, consistent with the principles of workable competition that:

> "At a minimum the mechanism should be available for changes in statutory requirements placed on the business, including changes to work safety requirements and environmental requirements".[2]

TXU advocates that these costs should be passed through to customers as part of an annual tariff approval process to the ACCC.

2.5 Weighted Average Cost of Capital

TXU recommends that the DRP provide a risk-adjusted rate of return, which embodies the regulatory developments since the initial development of the DRP's. These developments include:

- A balance between the interests of service providers and customers as reflected in the conclusions of the Productivity Commission's Review of the National Access Regime;
- A greater focus on incentive arrangements which promote dynamic efficiencies, which is supported by the outcome of the Dampier to Bunbury Pipeline Decision;

These developments and the implications for determining the cost of capital financing are outlined below.

There have been a number of independent regulatory developments and reviews since the release of the initial Draft Regulatory Principles (DRP) by the ACCC. Given, these developments, it is timely that the DRP be reviewed to reflect these developments.

[2] IPART: 2004 Electricity Distribution Review – Preliminary Analysis, Secretariat Discussion Paper, September 2003, p.5.

TXU believes that the ACCC should give effect to the Productivity Commission's conclusions in its recent *Review of the National Access Regime* in its Draft Regulatory Principles. The Productivity Commission recently reiterated these conclusions in an address to a business symposium on economic regulation that:

> "While the Commission has found that regulation appears warranted, it has signalled a need for greater legislative recognition – both in the application of regulation and the setting of terms and conditions – of the trade off between cheap services today and inadequate services tomorrow".[3]

These conclusions have also been reinforced by the Supreme Court Decision in Western Australia, in relation to the Dampier to Bunbury Pipeline ('the Epic Decision'). This Decision concluded that regulatory arrangements should promote 'workable' or effective competition rather than theoretically competitive markets in determining regulated outcomes. Most importantly, this highlights that Regulators' should ensure that the regulatory regime provides incentives to promote dynamic efficiency. TXU supports these findings, as a primary objective of any regulatory regime should be to provide appropriate incentives for ongoing investment to ensure the long-term interests of both customers and service providers.

In contrast to the findings of the Productivity Commission, the ACCC's views in relation to the cost of capital and its approach to the extension and assessment of the application of the regulatory test on an ex-post basis is likely to further reduce incentives to invest and increase regulatory uncertainty. Moreover, it appears to be focused on the short term to the detriment of the long-term interests of customers and network operators and does not provide an appropriate balance between the interests of both parties.

Specifically, the ACCC's preliminary position of focusing on WACC input parameters does not appear to have regard for sufficient incentives for long-term investment. The shortcoming and limitations of the asset-pricing model used to estimate the cost of capital are well known by academics and market practitioners. The ACCC has also acknowledged the theoretical and empirical limitations of this model in its submission to the Gas Code Review.[4] TXU maintains that the asset-pricing model used to estimate the cost of capital should only be used as a guide as the inputs cannot be observed or estimated with a high degree of precision. More importantly, these considerations need to be taken into account in any determination.

A comprehensive survey undertaken by NECG for the Productivity Commission's Review of the Gas Access Regime comparing rates of return in Australia, and overseas concludes that returns on infrastructure assets in Australia are not favourable. Indeed, the study found that regulated returns in Australia are less generous than in the United States. The study further finds that:

> "There is little evidence to suggest that the regulatory environment in Australia provides offsetting benefits to the business. There is still greater uncertainty in Australia associated with the application of optimisation-based approaches to asset valuation than in other countries. In addition, there is significant uncertainty over various WACC parameters, notably the risk free rate, where the ACCC….continue to adopt a position contrary to that of all other regulators in Australia or overseas".[5]

TXU would expect the ACCC to take these considerations into account as part of its cost of capital determinations.

In addition, the ACCC in its DRP proposals does not appear to acknowledge the interdependencies between the regulatory environment and the cost of capital. TXU considers that the ACCC's initial view

[3] 'The good, the bad and the ugly: economic perspectives on regulation in Australia', Gary Banks, Chairman, Productivity Commission: Address to the *Conference of Economists, Business Symposium*, Hyatt Hotel, Canberra, 2 October 2003.

[4] ACCC: Submission to the Productivity Commission, Review of the Gas Access Regime, 15 September 2003.

[5] 'International comparison of WACC decisions', Submission to the Productivity Commission Review of the Gas Access Regime from the Network Economics Consulting Group, September 2003, p.6.

of applying the regulatory test on an ex-post basis will result in an increase in the required cost of capital to compensate investors for this additional risk.

TXU believes that the DRP should give affect to the Productivity Commission conclusions and incorporate conservative assumptions in its WACC determinations.