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14 June 2002

Mr Michael Rawstron,
General Manager,
Regulatory Affairs – Electricity,
ACCC,
PO Box 1199,
Dickson, ACT 2602.

Dear Mr Rawstron,

RE: Issues Paper Review of the Regulatory Test

TransÉnergie Australia Pty Ltd (TransÉnergie) considers that network development is a key outstanding issue within the National Electricity Market (NEM). Central to the resolution of that issue is the framework and methodology applied to the justification of regulated network investments through the Regulatory Test. As a developer of network services in the NEM TransÉnergie is therefore pleased to contribute to this consultation.

For ease of interpretation, the format of this submission is that adopted by the ACCC in ‘Section 4 Issues for the Commission’ of the paper ‘Issues Paper Review of the Regulatory Test’, dated 10 May 2002.

Maximising Net Benefits

In its current form the Regulatory Test requires that in order to be justified a proposed project ‘maximises the net present value of the market benefit having regard to a number of alternative projects, timings and market development scenarios’. That is, not only is the proposed project required to have a net market benefit, it is required to be evaluated against a range of alternatives. The project is only justified if it achieves the highest net market benefit (the highest positive net present value (NPV)) and is therefore deemed to be the most efficient investment.

The Regulatory Test also recognises that some investment options may need to be undertaken ‘to meet an objectively measurable service standard linked to the technical requirements of schedule 5.1 of the National Electricity Code (the Code)’ even when there was no positive net benefit to the market - so-called reliability investments. In these cases the Regulatory Test relies on a slightly different approach more akin to cost-effectiveness analysis, whereby the objective (enhanced reliability) is taken as a given and the preferred investment is that which provides the lowest-cost means of obtaining that objective i.e. that which minimises the net present value of the investment costs. A cost-effectiveness analysis is reasonable where the valuation of the benefits is not possible, but should not be used as the basis of endorsing an investment where valuation of reliability benefits may be possible, or to avoid the focus on an otherwise negative or low benefit-cost ratio/NPV relative to alternative projects.

This review raises the issue as to whether the current requirement to maximise market benefits is too high a hurdle and whether a nominated NPV hurdle would be more appropriate. TransÉnergie firmly believes that the current approach is entirely appropriate and consistent with the principal of increased efficiency through the use of competitive markets that is reflected throughout the Code and other documents outlining the basis of the National Electricity Market (NEM). Subject to the comments below in relation to reliability investments, TransÉnergie strongly opposes any and all attempts to introduce notional hurdle levels that allow an easier approval for regulated projects that are effectively outside of the competitive market framework.

Hurdle rates are often used to reduce the number of investment projects to be considered. This is usually because of two factors viz:

- the total costs of all projects exceeds the total funds available for investment, or
- a higher level criteria is determined as appropriate. For example, expected rates of return are sometimes set at a specified level to reflect risk factors not incorporated in the NPV discount factor, or the required return from an investment is set at a minimum level, usually to reflect the cost of capital.

Hurdle rates should not be used as a mechanism to help regulated projects gain easier approval, and by doing so undermine the competitive market response. TransÉnergie has consistently maintained that the Regulatory Test should ensure competitive neutrality between market-based and regulated projects, and that regulated projects should only proceed in cases of market failure. Apart from the fact that customers will directly bear the costs of these regulated projects through inefficient Transmission Use of System (TUOS) charges, it is particularly important that the ACCC avoid setting 'easier targets' for regulated investment proposals because this would:

- (a) represent a further step away from the market-based investment decision methodology that the Regulatory Test is trying to emulate;
- (b) further distort an already uneven playing field between regulated and market based investments that is slanted towards regulated investments;
- (c) allow regulated investment options to pre-empt market solutions; and
- (d) effectively represent another barrier to entry by market-based solutions.

TransÉnergie does concede that other considerations, such as capital rationing, may also be relevant in the investment process. For example, it may be more appropriate to have regard to expected future investment opportunities or requirements. If for example, a TNSP expects that it will be required to invest in a number of future projects, it may be appropriate to select current projects that achieve the principal objective (positive NPV) but trade-off maximising net benefits for availability of funds to undertake the future projects. In the case of regulated investments, the decision may be to lessen the burden of current TUOS charges on customers in the knowledge that additional TUOS charges will be forthcoming in the future.¹

¹ Commercial decision-making does not necessarily rely on just one method for ranking investment options or deciding which option will proceed. Other principal methods include calculated rates of return, payback periods, internal rate of return (IRR) and net present value per dollar invested (NPVI).

Reliability Driven Augmentations

TransÉnergie supports the principle thrust of the Regulatory Test, including the approach supporting reliability investments. However, as TransÉnergie highlighted in its submissions to the Commission during the Network and Distributed Resource (NDR) Code change consultations, the Code and the Regulatory Test do not put sufficient emphasis on ensuring that TNSPs are correctly classifying projects as reliability investments. In addition, there appears to be an implied assumption that only TNSPs are able to provide solutions that maintain reliability levels. In fact, TNSPs should first seek market-based outcomes to satisfy their reliability requirements at lowest cost to the market.

It is incorrect to assume that reliability investments will always be associated with a negative benefit-cost ratio, and therefore the market will fail to undertake such investments. This presumption is reinforced by the Regulatory Test's evaluation process, which explicitly assumes there is a reasonable benefit associated with reliability but fails to enforce any requirement on TNSPs to objectively determine a value for those reliability benefits. The current form of the Regulatory Test also presumes that the TNSP is able to undertake an investment at a lower cost than any other party.

TransÉnergie supports a mechanism within the Regulatory Test (or preferably within the Code itself) whereby a TNSP that identifies that an investment is required in order for the TNSP to meet its reliability or other minimum performance standards, must formally seek alternative solutions, including the requirement to undertake the investment from the open market (through a competitive tender process). This process provides all market participants with an opportunity to put up alternative solutions, some of which may have net market benefits. Where a number of alternative market based solutions are proposed, the TNSP should be obligated to evaluate all proposals, including any of its own options, by either maximising the net benefits or minimising the net costs in accordance with the Regulatory Test. Recognising that alternative projects may provide varying levels of reliability over and above the necessary minimum levels, the evaluation process would be enhanced where the TNSP is also required to evaluate the value of the level of reliability achieved by each project.

Competitive Impacts of Network Investment

TransÉnergie agrees that by focussing heavily on the results of benefit-cost analyses the Regulatory Test may not fully recognise the competitive benefits of network investment. TransÉnergie's position is that there are competitive benefits induced by network investment.

It remains, however, that additional secondary, indirect, induced, or transmitted competitive benefits and other 'positive externalities' may not be captured through the current application of the Regulatory Test. This is not an issue confined to the NEM or electricity markets, but is an issue that has also been evaluated in other large-scale infrastructure industries (eg transport). However, it is not impossible for the benefit-cost analysis to include, albeit obliquely, these benefits through inferred benefits of overall market outcomes. However, if attempts are made to measure the additional benefits separately, a whole gamut of new problems arise, none the least being how to actually measure or place a value on their worth without the problems of double counting.

At this stage, other than through the rationale of traditional economics and competitive markets, TransÉnergie has no firm basis on how to form a view on whether the Regulatory Test should or should not include a competition test. Given the strong preference for market-based outcomes and an underlying philosophy that competition provides an opportunity to add value and benefits to the market, TransÉnergie would however support the ACCC taking a leading role in researching this concept further.

Network and Distributed Resources Code Change Package

During the development of the NDR Code changes TransÉnergie made a number of submissions highlighting various key concerns. Whilst the Commission did address some of these concerns, TransÉnergie maintains that a TNSP still has the potential to misuse its monopoly position to the detriment of market participants.

The Commission's Issues Paper asks whether the Regulatory Test should be more prescriptive. Prior to the NDR Code changes, TransÉnergie might not have supported a more prescriptive approach for the Regulatory Test, although we would agree that various definitions and concepts needed to be clarified and better defined to avoid inconsistency with the Code. However, now that the Regulatory Test is conducted by individual TNSPs themselves, TransÉnergie believes the Commission should take a more rigorous approach to defining the boundaries of the Regulatory Test. With multiple parties applying the Regulatory Test, it would not be surprising to see multiple and possibly conflicting interpretations of its application being adopted to suit individual needs. This will diminish the value and effectiveness of the Regulatory Test and ultimately lead to a high incidence of issues being referred to the dispute resolution process.

The Commission's Issues Paper also seeks comments on whether a market test period, in which market based alternatives to regulated network investment are given a specified time in which to respond alleviate to network constraints, should be introduced into the Regulatory Test. Consistent with previous discussions TransÉnergie believes that it important to ensure competitive neutrality between regulated and market based investments, and that therefore regulated investments should not pre-empt market-based solutions. All attempts should be used to promote competitive market solutions, even where reliability investments may be necessary.

Timing Delays

TransÉnergie notes that various key processes required by the Code are hampered by the absence of defined time periods for the carrying out or completion of relevant activities or decisions. Apart from failing to promote efficiency and effectiveness through prompt decision-making practices, this leaves open the possibility that various entities can directly or indirectly manipulate the competitive position, and ultimately cost effectiveness, of other participants in the market. By being in a position to frustrate due process, at best a form of strategic gamesmanship or at worst outright abuse of market power or authority, entities can potentially add costs to market operations, lead to inappropriate investment decision-making and generally detract prospective market investors away from the Australian electricity market to countries with less sovereign and regulatory risk. Moreover, the lack of timing constraints on critical processes tends to entrench the existing monopolistic position enjoyed by the TNSPs.

TransÉnergie believes the NDR Code changes provide reasonable timeframes for the relevant parties to assess regulated proposals. Whilst TransÉnergie supports the concept of a streamlined process for regulated network planning, it does not support the TNSPs' notion that this necessarily translates to short or minimal periods of assessment and consultation. A key aspect of the NDR Code changes is that, by prescribing maximum time periods,² there is far greater certainty in regards to the specific timing for the overall assessment and approval process. No further changes are considered necessary in this regard.

Other Issues for Consideration

Is the choice of discount rate, being the appropriate rate for the analysis of a private enterprise investment in the electricity sector, still appropriate?

TransÉnergie supports the current approach of applying a single discount rate, and that this should be representative of a commercial/market discount rate as opposed to any form of a lower 'social' rate.

Discounting is used to scale the magnitude of intertemporal costs and benefits according to time. In the context of the Regulatory Test, and to the extent that discounting is not associated with removing the effects of inflation, the principal justification for discounting is that, to be comparatively worthwhile, regulated investments should at least match the rate of return on private investments. Therefore, basing the discount rate on the appropriate private rate of return benchmark is the logical mechanism to impose equality between regulated and market based investments.

TransÉnergie would also strongly argue that the discount rate used to evaluate the worth of proceeding with a regulated investment pursuant to the Regulatory Test should be closely linked to the determination of the WACC used to calculate the maximum return attributed to that asset in any subsequent revenue cap decision. That is, if a lower discount rate is used in the Regulatory Test, effectively signalling that there is less risk of the benefits being achieved, then the revenue cap determination should reflect a similarly lower WACC reflective of the lower risk that returns will be achieved.

Should there be specific requirements for competitive tendering that could form the basis of a safe harbour provision?

Refer the earlier discussion on maximising net benefits.

TransÉnergie looks forward to participating in the future development and refinement of the Regulatory Test. Please do not hesitate to contact me should you require clarification of any of the issues raised in this submission.

Regards,

Dr. A. Cook

THIS SUBMISSION HAS BEEN SENT ELECTRONICALLY AND THEREFORE BEARS NO SIGNATURE

² As highlighted by the Commission in its NDR determination, the specified time periods are the maximum time periods in which the IRPC, dispute resolution panel or the Commission must complete its relevant process, decision, assessment or resolution and that if the relevant entity is able to complete such within a shorter, then it is obliged to do so.