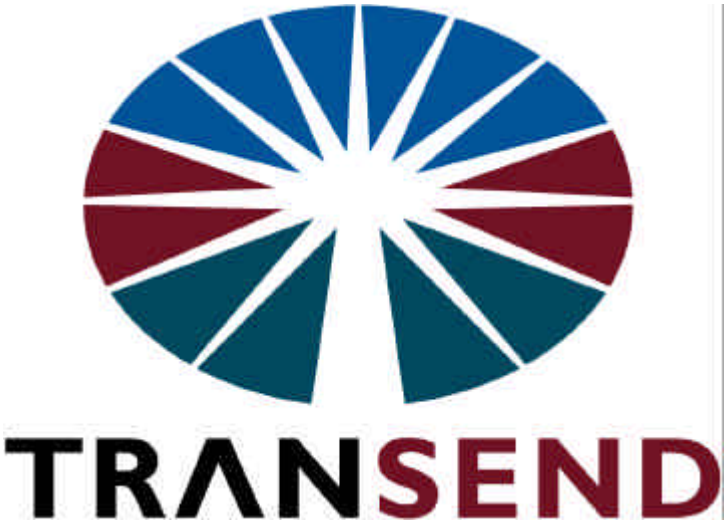
Regulatory Test



Submission for the
Review of the Regulatory Test
conducted by the
Australian Competition and Consumer Commission

Transend Networks Pty Ltd

April 2003

Review of the Regulatory Test

Submission

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ACCC Review of the Regulatory Test

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1.0 Introduction

Transend provides the following brief comments on the Australian Competition and Consumer Commission's (ACCC) Discussion Paper of February 2003 regarding its review of the Regulatory Test as an interested party, particularly given Tasmania's impending entry into the National Electricity Market (NEM). Transend expresses its appreciation to the ACCC for granting it a time extension.

1.1 Essential Services Commission Submission

Transend notes the letter provided by Lew Owens, Chairman of the Essential Service Commission of South Australia in response to the review of the Regulatory Test and in particular his comments regarding the limitations of modelling and his view that decisions on interconnections between jurisdictions are political decisions. Transend acknowledges that there are limits to the robustness of economic modelling approaches and that often there are political issues in relation to significant network investments and that this will continue in future. However, the market and political environment is developing such that network investment decisions are increasingly independent of governments and subject to commercial and regulatory decision processes.

1.2 Maintain Regulatory Test

Transend agrees with the ACCC that there are advantages in maintaining the Regulatory Test in its current form given that it has been applied on a number of occasions and has been subject to an appeals process. The Regulatory Test will necessarily evolve and become more prescriptive over time either through the application of the Regulatory Test and any appeals processes, setting precedents and/or through review processes, such as this, resulting in further clarification

of the application of the Regulatory Test. However, it is important that the two processes do not conflict with each other, reducing the potential benefits to be gained from reduced regulatory uncertainty. Therefore, the outcomes of this review process should remain consistent with the historical application of the Regulatory Test. For example, the Regulatory Test should not be amended in ways that are inconsistent with any ruling of the National Electricity Tribunal.

1.3 Tasmanian Transmission

Tasmania will enter the National Electricity Market six months prior to the completion of the Basslink interconnector. The ACCC is currently considering the Transend revenue cap application.

Historically, the Tasmanian electricity supply industry has placed a greater emphasis on hydro-generation development than on transmission expenditure. While Tasmanian transmission will be a relatively small component of the NEM system, it is in a comparatively poor condition and Transend is undertaking a relatively high level of investment which includes some major projects.

Transend applies the principles inherent in the Regulatory Test to all material investment decisions. However, as in other jurisdictions, many of these assets will not be subject to the specific application of the Regulatory Test processes. Many of the projects are replacement or refurbishment assets and others will not exceed the threshold limits applying to the Regulatory Test. Further, most network augmentations that do meet the Regulatory Test thresholds will be reliability augmentations. However, Transend and the jurisdictional regulator have already successfully applied the Regulatory Test process, under the existing Tasmanian arrangements, to a number of projects including the Tasmanian Southern Transmission Upgrade project.

1.4 Transend Comments

The ACCC should take a more prescriptive approach to the amendment of the Regulatory Test than the amendments proposed in the Discussion Paper and a different approach should be adopted in respect of some elements of the Regulatory Test, as discussed below. However, Transend also has concerns that relate to the application of the Regulatory Test as determined in the National Electricity Code (Code) and the relationship between the Regulatory Test and the revenue review process, which are discussed below.

2.0 Regulatory Test Comments

The Regulatory Test can be more prescriptive while avoiding conflict with historical precedents and allowing flexibility in the assessment of different investments. Detailed examples that demonstrate how the Regulatory Test is to be applied in practice should also be included with the notes on the methodology to be used in the Regulatory Test. The more prescriptive the Regulatory Test is, the lower the chances of costly disputes arising.

The ACCC has proposed changes to the Regulatory Test in relation to reliability augmentations that duplicate the provisions of the Code and are therefore not required. The Regulatory Test can provide for the inclusion of competition benefits and this should be clarified. The value of energy to consumers and the discount rate used in the Regulatoty Test should be changed.

2.1 Reliability Augmentations

The ACCC Discussion Paper (page 37) has proposed to incorporate into the Regulatory Test, notes on reliability augmentations. These would require a network service provider to disclose information in respect to reliability augmentations that duplicate Code requirements.

Following the Network and distributed Resources amendments, the Code (S5.6.5 (b)(5)) requires that an applicant who proposes a large network augmentation must make available a notice that includes:

'Detailed analysis of why the applicant considers that the *new large network asset* satisfies the *regulatory test* and, where the applicant considers that the *new large network asset* satisfies the *regulatory test* as the *new large network asset* is a *reliability augmentation*, analysis of why the applicant considers that the *new large network asset* is a *reliability augmentation*. In assessing whether a *new large network asset* is a

reliability augmentation, the applicant must consider whether the *new large network asset* satisfies the criteria for a *reliability augmentation published* by the *Inter-regional Planning Committee* in accordance with clause 5.6.3(l) (if any such criteria have been *published* by the *Inter-regional Planning Committee*).'

Therefore, the proposed changes to the Regulatory Test will duplicate the Code provisions.

Such obligations are properly included in the Code, as described above, and should not also be included in the notes to the Regulatory Test. The Regulatory Test is applied to augmentations as determined by the Code and the notes on the methodology to be used in applying the Regulatory Test to a proposed augmentation provide clarification. The Regulatory Test notes should therefore, simply explain how the Regulatory Test is to be applied. The notes should not impose additional obligations such as the information disclosures suggested by the ACCC in relation to reliability augmentations.

2.2 Competition Benefits

Transend agrees with the ACCC that the current Regulatory Test allows for competition benefits to be included under the market benefits test. However, Transend also agree that there are different methodologies and their application is difficult. Consequently, Transend proposes that the Regulatory Test be changed to confirm this option but that the onus remains upon the proponent to demonstrate any material competition benefits. These benefits will be in addition to the list of benefits that the ACCC is proposing to include in the Regulatory Test. The proponent would not be limited in the methodology they chose to apply and the ACCC could ultimately determine any competition benefits if it makes a determination in response to any objections to the augmentation.

2.3 Value of Energy to Consumers

The value of energy to consumers can exceed the wholesale market cap. The wholesale price cap (VoLL) is set at a level that is less than the value consumers place on reliability and therefore is not appropriate for the Regulatory Test.

The wholesale market provides the current level of reliability and peak generation due a variety of factors including:

- historical (pre market) generation plant and transmission investments
- increased market power of generation at peak times increasing the returns from peak generation, and
- the reserve trader mechanism.

The recent ACCC draft determination has accepted an extension of the reserve trader provisions of the Code. Additionally, previously the ACCC has accepted an increase in the wholesale cap to $10,000/MWh expressing opinions to the effect that (but for other temporary constraints such as risk management and market power issues), the cap could be increased further to $20,000/MWh and expressing concerns regarding market price signals with a price cap. These determinations would imply that the ACCC believes that the current level of VoLL is inadequate to deliver end use customer reliability. Therefore, the actual value of reliability of supply to electricity consumers should be used rather than VoLL in relation to the Regulatory Test. For simplification and certainty, this could be included as a set value within the Regulatory Test that is not less than $20,000/MWh. Alternatively, a set of values could be used that reflect the impact of different augmentations upon different customer classes, each with their own view on the value of unsupplied energy.

2.4 Discount Rate

Transend believes that the discount rate that should be applied to transmission investments should be the regulated weighted average cost of capital (WACC) as determined by the ACCC. This usually results in a discount rate that is lower than that applied by any alternative projects proponents such as any generation or demand management options. However, this is reflective of the comparatively lower cost of capital for many transmission investments and hence, should be used in the analysis as it reflects actual costs. Significant actual transmission capital investments are made by 'for profit' transmission businesses (including private enterprises) on the basis of regulated WACC based returns and it is appropriate that these be comparable to the rates of return on which other investments are made in the market. Consequently, the Regulatory Test should be amended to clarify that the net present value of calculations should use a discount rate applicable to the proposed augmentation investment (i.e. the regulated WACC).

3.0 Related Issues Comments

Interested parties have commented on a number of issues that are related to the Regulatory Test. In addition, there are a number of broader issues under consideration by the Council of Australian Governments and the NEM Ministers' Forum that relate to the Regulatory Test process. Transend does not propose to comment on these broader issues here. However, Transend does provide the following comments on issues directly related to the application of the Regulatory Test. Transend believes that these issues should be addressed through the Code change and the ACCC's Statement of Regulatory Principles development processes.

3.1 Replacement and Refurbishment Assets

Transend notes the ACCC's view expressed in the Discussion Paper (page 27) that if a TNSP replaces an existing asset, only that part of the investment project that augments the network is subject to the Regulatory Test (if it meets the threshold limits). This avoids small augmentations associated with replacement and refurbishment assets from being subject to the Regulatory Test. However, Transend believes that the Code should be amended to clarify this position.

This clarification would also avoid the risk of larger asset replacement or refurbishment projects, with associated minor network augmentations, from being subject to the Regulatory Test (where they do not meet the appropriate thresholds).

Further, the replacement and refurbishment of assets may even result in the capacity of the network being incidentally increased without there being any requirement to do so, for example:

- technology developments may result in an “unavoidable” increase in capacity (where the most cost effective replacement asset has a higher capacity)
- electricity industry practice may dictate the use of higher capacity plant (for example, to ensure compatibility with similar plant in a network), and/or
- the additional capacity may be possible at small or negligible cost (for example the addition of cooling fans on transformers).

These assets should not be subject to the Code Regulatory Test process.

The review of replacement and refurbishment capital expenditure should form part of the normal revenue setting processes and be considered in detail in the ACCC’s Statement of Regulatory Principles for the Regulation of Transmission Revenues.

3.2 Thresholds

The thresholds for the application of the Regulatory Test are too low and the rationale for the limits is not clear. Transend notes that the Code allows the ACCC to amended these thresholds. These limits should be raised by preferably amendment to the Code, or alternatively by ACCC determination.

There will continue to be uncertainty and complexity in the application of the Regulatory Test and the costs of applying the Regulatory Test and undertaking the consultation processes are significant. The costs of modelling alone may exceed $100,000. Moreover, the indirect costs of management and staff time are also substantial. Moreover, the application of the Regulatory Test exposes network service providers to the direct and indirect costs of potential regulatory and legal disputes.

Therefore, the thresholds for small and large network assets should be raised and a detailed explanation provided as to the basis of the levels.

3.3 Revenue Regulation

Transend notes the ACCC's comments in the Discussion Paper (page 27) that it acknowledges the response of interested parties to the issue of optimisation and will consider this issue further in its finalisation of the ACCC's Statement of Regulatory Principles. To be consistent with this approach, S5.6.6(p) of the Code that requires that any determination of the ACCC in relation to the Regulatory Test shall only apply until the end of the regulatory control period in which the determination is made, should be removed to allow such determinations to apply for the economic life of the assets.

Transend would prefer that this Code provision (S5.6.6(p)) be replaced with a new provision that requires that where it has been demonstrated through the Code process that a large augmentation meets the Regulatory Test process it should not be subject to optimisation. This should apply to any large augmentation whether or not an objection has been raised and a determination made by the ACCC in relation to that asset. Other smaller augmentations should be subject to the normal revenue determination processes.

Any large network augmentation that is subject to the Code consultation processes and any participant who may be adversely impacted by a large augmentation investment has the opportunity to object to the augmentation and ultimately seek a determination by the ACCC. Additional regulatory reviews only impose additional costs on the market through increased regulatory risk.

Large augmentation assets are more likely than most other network assets to be optimised due to:

- their addition to the existing network
- large size
- ability to be identified separately from the network, and
- the financial impact on other market participants.

However, having met the Regulatory Test, the asset owner should be able to rely on that assessment rather than being subject to periodic future reviews, over the economic life of the assets.

Customers and other market participants are protected from inefficient investment by the Code Regulatory Test processes and subsequent reviews only add regulatory uncertainty costs to an existing asset. Although the application of the optimisation provisions may be unlikely, the risk of the potential financial impact to an otherwise relatively low risk transmission business are significant.

A supplement to this approach would be for network service providers to be paid a premium rate of return on these riskier large augmentation assets and to receive an accelerated depreciation allowance should these assets later be subject to optimisation.

4.0 Further Discussions

Transend would welcome any opportunity to further discuss these issues and the future application of the Regulatory Test in Tasmania. The Transend contact is Michael Green, Executive Manager Tasmanian Wholesale Electricity Market Project.

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