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Dear Sebastian

Murraylink – Application for Conversion to Regulated Status

The Energy Users Association of Australia (EUAA) appreciates this opportunity to provide a submission to the Australian Competition & Consumer Commission (ACCC) setting out its views on the application by Murraylink to convert from its present status as a Market Network Service Provider (MNSP) to regulated status under the National Electricity Code.

The attached submission sets out our views on the application, which are formed solely on the basis of what is in the best interests of energy users. To our knowledge at the time of writing, this is the only substantive submission that the ACCC has received with a pure user focus and directly representing the interests of energy users in South Australian and elsewhere. The EUAA is uniquely placed to provide the ACCC with such a view, given its involvement in both national and state issues and its position as the national association of energy users.

The EUAA has held several discussions with Transenergie during the course of preparing this submission and a number of matters are the subject of continuing dialogue. Should this significantly modify our current position, we will advise the ACCC accordingly.

If you have any questions about the submission or would like to discuss it further please do not hesitate to get in contact with me.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Roman Domanski", with a flourish at the end.

Roman Domanski
Executive Director

**Murraylink – Application for Conversion to Regulated Status
Application and ACCC Issues Paper
Response by the Energy Users Association of Australia**



The Energy Users Association of Australia (EUAA) appreciates this opportunity to provide a submission to the Australian Competition & Consumer Commission (ACCC) setting out its views on the application by Murraylink to convert from its present status as a Market Network Service Provider (MNSP) to regulated status under the National Electricity Code.

This submission sets out our views on the application, which are formed solely on the basis of what is in the best interests of energy users. To our knowledge, this is the only substantive submission the ACCC has received with a pure user focus and directly representing the interests of energy users in South Australian and elsewhere. The EUAA is uniquely placed to provide the ACCC with such a view, given its involvement in both national and state issues and its position as the national association of energy users.

Context

Adequate interconnection is vital to the National Electricity Market (NEM) and to energy users dependent on that market to deliver continuous supply of electricity at a competitive price. Interconnection is one significant key to lessening the extent of market power, improving competition, enhancing interstate trade and liquidity and ensuring adequate supplies of electricity. However, it is generally accepted that there is insufficient interconnection in the NEM and the recent Parer Report on Energy Market Reform has recognised this as a problem needing urgent attention.

Hence, the EUAA has supported more interconnection for several years and made this one of its key priorities.

The EUAA has generally favoured the use of regulated interconnectors in the NEM under current circumstances where there is a need for substantial additional links across State boundaries. We believe that regulated links will deliver maximum benefits to energy users from interconnection. Although costs are “smeared” across all customers through transmission use of system (TUoS) charges, the benefits of substantial additional interconnection are likely to be much greater than the costs.

However, we have not opposed merchant links. Although not as beneficial as regulated links and likely to be prone to some problems that regulated links avoid (eg below optimum capacity, incentives to exploit market power, doubts about whether they can co-exist successfully with regulated links), they are a

facility whose risks are borne by investors and they can play a role in the NEM.

The proposal by merchant link company Murraylink to convert to regulated status raises some vexed and important issues that will impact on energy users. The remainder of this submission sets out our views on these issues.

Code Provisions on Conversion

The Code clearly provides for a MNSP to apply to convert to regulated status. Therefore Murraylink is entitled to apply.

Is conversion desirable?

However, it is arguable whether this should be the case and whether this provision should even be in the Code. We are unsure as to why it is and what public benefits were expected to derive from it?

In any case, Murraylink clearly must have believed that it could be profitable as an MNSP and took this risk, albeit with a known option to convert to regulated status at any time. Although an entrepreneurial facility it, unlike other entrepreneurial operations in the NEM, is in the unique position of being able to apply to convert to regulated status. This option is not available to generators, for example, who compete with Murraylink for despatch in the NEM. It is arguable if the availability of this option may have even influenced the original decision to build Murraylink and skewed the decisions of investors in it. Indeed, Transenergie was involved in the NECA's deliberations on the Code's approach to MNSPs.

We believe that the ACCC should comment on the conversion option in its decision on Murraylink's application and consider the need for removal of the option if necessary. In this case, it would not seem logical to proceed with the application.

The remainder of this submission is written on the basis that the provision to convert remains and the ACCC proceeds with the application by Murraylink.

Amount of discretion

The Code provision also allows the ACCC considerable discretion in determining how to proceed with an application for conversion. In our view, this is possibly because the authors of the provision were themselves unsure as to how to assess such an application. Nevertheless, we believe that the discretion available is far too wide and it would be desirable if the ACCC used this application to provide some clarity and consistency about future decision-making in this area, assuming the conversion option stands. This is particularly important given that this is the first application for conversion and will inevitably establish precedents.

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We would urge the ACCC to use the Code and National Electricity Law objectives as a basis for ensuring consistency in decision-making. The ACCC's Statement of Regulatory Principles and criteria for assessing access applications may provide additional useful means of developing a transparent approach to assessing applications for conversion.

'Once only' conversion

We strongly believe that conversion should be a 'once only' option. That is, if its application succeeds, it should not be allowed to revert to a MNSP at some later point.

Allowing MNSPs unfettered switching of their status would be highly undesirable and encourage 'regulatory shopping' and gaming. For example, tactical manoeuvring to fend off or delay the building of other 'competing' facilities would be more likely. This would be highly undesirable and could damage investment in the NEM (generation, transmission and demand management).

Furthermore, merchant links based on strong initial cash flows might be built only to see the well-known vagaries of the NEM spot market destroy these with the owner then making use of the option to convert to regulated status. This would be even more likely if Murraylink's application were granted, especially on the basis of a favourable RAV.

The ACCC also needs to carefully and consistently apply the regulatory test in this case, lest other TNSPs seek to exploit any gaps that favour them in future. In this regard, we note Powerlink has already signalled an intent to exploit any such gaps.

This would also send a poor signal to the builders of other prospective regulated interconnectors who would risk being gazumped by MNSPs. We believe that customers would be worse off for this and urge the ACCC to guard against it.

Murraylink as a Prospective Regulated Interconnector – End User Issues

Should the ACCC grant Murraylink's application to convert to regulated status, there are several important issues to consider regarding the terms and conditions of conversion. These are discussed in this section in terms of their impact on end users, the EUAA's key consideration.

First and foremost, the EUAA would expect the ACCC to only permit conversion on the basis of a rigorous analysis ensuring that customers benefit from conversion more than they do by either having Murraylink remain as a merchant link or from the alternatives to Murraylink.

Relevant matters are set out below.

Murraylink's Application and the Regulatory Test – Establishing a Regulatory Asset Value

We are concerned that the Application appears not to have followed established procedure under the regulatory test and urge the ACCC to ensure this happens. The regulatory test has been established for the purpose of determining the benefits associated with approving regulated interconnectors and we expect Murraylink's conversion to regulated status to pass it. Otherwise energy users could be materially disadvantaged by conversion.

We note NERA's comment that (in their report prepared for Transgrid and provided to the ACCC):

A comparison of the net benefits requires an assessment of the gross benefits of each alternative [project], as well as an analysis of their costs. Murraylink's Application only considers the costs of alternative projects.

In order to ensure that a RAV is chosen for Murraylink such that it satisfies the regulatory test, Murraylink's proposed approach would need to be amended to incorporate a comparison of the net market benefit provided by alternative projects. To the extent that alternative projects have a positive net market benefit, this reduces the RAV derived for Murraylink."

We believe that the ACCC needs to seriously consider this comment and ensure that Murraylink complies fully with the regulatory test.

Furthermore, Murraylink is an existing asset, whereas normally the regulatory test is applied to assets not yet constructed. It seems to us that this raises some important issues for the ACCC in terms of what is reasonable in these circumstances.

Recognising this, NERA also suggested that the ACCC:

... apply the regulatory test to the project specified as 'the change in status of Murraylink from a market network service provider (MNSP) to a regulated interconnector'. ... The *maximum* regulated cost that could be set for Murraylink would then be the lowest of the capex cost plus lifecycle opex costs for Murraylink; or the expected revenue for Murraylink if it continued to act as an MNSP plus the net benefit to the market of Murraylink changing its status from an MNSP to a regulated interconnector."

NERA go on to observe that this "forward looking" approach has advantages over "a hypothetical assessment of what alternatives could be built instead of Murraylink."

We believe that NERA's comments should be given serious consideration by the ACCC in terms of applying the regulatory test to conversion.

Moreover, it is important for the ACCC to recognise that Murraylink's assets are sunk. Economics would suggest that its conversion to regulated status is therefore worth somewhere between its scrap value and the replacement cost of the least cost option providing similar benefits. It would remain in

operation, even if its Application for conversion is rejected, so long as it covered its losses and opex.

The New South Wales Minister for Energy's submission calculates that Murraylink would operate at an average flow of 118MW (assuming favourable incentives to restrict flows) as an MNSP and 140MW as a regulated link. The net difference of 22MW provides an indication of the degree of (maximum) incremental benefit of Murraylink as a regulated link.

Applying the Regulatory Test to Murraylink – Consideration of Project Costs and Benefits

If the ACCC considers the Application in terms of comparing the net market benefits of Murraylink to alternative projects, it must do so in a manner that is consistent with past application of the regulatory test. Murraylink's Application seems deficient in this area in several respects and the Applicant should be asked to address these.

In the first place, the Application ignores the fact that Murraylink is already operating as an MNSP and therefore has significant sunk costs (see discussion in section above).

Secondly, the Applicant has applied the regulatory test to some alternative projects that offer the same level of *technical* benefit as Murraylink. However, this resulted in the exclusion of demand management and generation projects on the basis that they could only meet Riverland requirements and "were not equivalent to Murraylink". Nevertheless, this leaves users in the position of not knowing the extent and value of these alternatives as well as being a rather cursory treatment of the relevant requirements of the test. Again, energy users could be materially disadvantaged by this approach and we request that the ACCC ask Murraylink to carry out a more complete evaluation of these alternatives and to expose this to public scrutiny.

We note that the ACCC has recognised that, in applying the regulatory test, a variety of projects could deliver similar benefits and costs, whilst recognising that the issue to determine is the extent of net market benefits rather than obtaining the same technical service (or gross market benefit). Therefore a project that delivers similar benefits to Murraylink would be a more appropriate benchmark for costing alternatives and would probably mean a substantial reduction in Murraylink's regulatory cost base.

This *technical* approach also restricts alternatives to projects offering the same service as Murraylink, which according to the Application "required AC transmission alternatives to include both phase shifting transformers and static var compensators", which adds significantly (\$20 million) to the cost of AC alternatives, even though technical experts question the need for this.

The Application also included undergrounding costs, even though this may be difficult to justify for a regulated link, a point supported in several other submissions. This adds \$68 million to the alternatives.

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The outcome of the above is to substantially ratchet up the alternative project costs and make Murraylink as a regulated interconnector seem considerably more attractive than it probably is in reality. If accepted by the regulator, this will lead to substantially inflated regulatory costs and higher transmission charges for energy users.

The Electricity Supply Industry Planning Council (ESIPC) queries the level of gross benefits claimed by Murraylink (\$214 million), particularly the deferral benefits of \$130 million, suggesting a figure below the \$32 million estimated for SNI. They also say that the benefits of Murraylink claimed for Riverlink deferral would be between zero (with SNI) and no more than \$10-15 million (without SNI), not \$26 million as stated in the Application.

Furthermore, questions were raised about the \$59 million claimed for 'other reliability benefits', which appears involves a different approach to that used by the IRPC.

We acknowledge that these capabilities could be useful but seek further information as to whether they are included in the regulatory test. If so, the added benefits ascribed to Murraylink need to be robust and verifiable. In this regard, we note that some alternatives not presently included, such as generation and demand management, can also provide additional reliability 'benefits'.

The above suggest some fundamental flaws in the present Murraylink Application, which the ACCC must ensure are addressed. Murraylink must be asked to broaden its range of alternative projects and to select these on the basis of maximising net economic benefits rather than merely achieving the same technical service.

Thirdly, there appear to be unresolved issues concerning the actual technical capabilities of Murraylink, especially its transfer capacity during peak times (a critical matter for valuing the benefits interconnectors provide to end-users). We were unable to find any verifiable information about this in the Application but note that NEMMCO's Statement of Opportunities for 2002 said that Murraylink would not provide any significant additional transfer capability at times of peak demand. This is a matter of considerable relevance to determining what extra value Murraylink will provide as a regulated link. The ACCC must ensure that Murraylink's peak capabilities are confirmed before it approves any Application for conversion and establishes a RAV.

We welcome the fact that Murraylink and Vencorp have apparently commenced consideration of this.

Other Gaps in the Murraylink Application

We believe that the following areas reveal gaps in the Murraylink Application, which we would expect the ACCC to clear up as they impact directly on the

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potential RAV and hence what energy users would have to pay following Murraylink's conversion.

- Murraylink propose a 'Vanilla WACC' of 9%, compared to around 8.25% in recent ACCC decisions on ElectraNet and SPI PowerNet. This translates to a return on equity almost 1% higher than the (already inflated) returns the ACCC allowed for ElectraNet and SPI PowerNet. This would mean higher charges to energy users for no justifiable reason and is not acceptable to the EUAA. We expect the ACCC to 'knock-down' Murraylink's WACC to a level (at least) more consistent with other regulated transmission.
- Murraylink use a commercial discount rate (9.25%) which is significantly lower than that used in other recent applications of the regulatory test (11%) and therefore likely to increase the RAV (and transmission charges).
- The calculation of gross market benefits includes around \$9 million in additional investments not yet committed to, whereas this appears not to have been included in the regulatory test analysis.
- The Application seems to rely on a level of spares, which it has been suggested could set a new (higher cost) benchmark for other TNSPs. Powerlink has already signalled its intention to apply that benchmark if the ACCC accepts it.

Treatment of SNI (and other possible upgrades)

As mentioned above, Murraylink's Application does not include SNI as an alternative project.

SNI has been approved by NEMMCO as a regulated link, a decision that has been confirmed in an appeal to the National Electricity Tribunal, although it remains subject to a further Court appeal. Unless the courts overturn the previous decisions, SNI would appear to have a clear path to construction. If this happens, end-users face a risk of both projects operating as regulated links, even though this seems to duplicate what does not need to be, with a potential combined RAV of up to \$300 million. This would be a severe and unjustified impost on energy users.

In these circumstances, we would expect the ACCC to re-optimize the assets of one or both projects to reflect overcapacity.

However, the ACCC finds itself in the difficult position of needing to consider an application from Murraylink, whilst at the same time facing uncertainty about the final status of SNI because the same party that has applied for conversion has also appealed the SNI decision to the Courts. This is a ridiculous situation, which highlights the shortcomings in transmission in the NEM. It could, however, be clarified by Transenergie/Murraylink either

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withdrawing their court appeal or this application (until the appeal has been decided). We would urge them to do so.

Alternatively, the ACCC could consider this situation in setting the terms and conditions for a regulated Murraylink. It should make clear that it will re-open Murraylink's regulated status with a view to a downward adjustment in its RAV if SNI or any other regulated augmentation proceeds. Another (less attractive) option would be to set a shorter regulatory period.

Service standards

We have major concerns with the proposed service standards for Murraylink as a regulated link. In particular:

- The target reliability factor of 97% seems too low for an overhead transmission line, let alone an underground one. The addition of a $\pm 1\%$ 'dead band' around this factor would blunt the target even more. We note that PB Associates report a performance level of $>98\%$ based on manufacturer's data.
- The proposed incentive scheme amounting to 1% of annual regulated revenue seems to us to be too low to provide sufficient reward/penalty to Murraylink, particularly given the magnitude of impacts that transmission outages can create in the energy market.
- Given that transmission outages can often be highly time critical in terms of their impacts on the energy market, it seems insufficient to allow a service standard based on a single reliability factor as if the actual moment in time that an outage occurred did not matter. We welcome Murraylink's apparent acceptance of the PB Associates recommendation that there be individual targets for planned, forced peak and forced off-peak outages. However, this only responds partially to the issue and the levels proposed need more scrutiny.
- The unchallenging levels proposed by Murraylink is at least partly due to the ACCC's overly cautious approach and reluctance in pressing this issue with TNSPs to date, despite the urgings of end-users and others.
- If the ACCC accepts low targets and incentives for Murraylink, it should ensure there is scope to make adjustments to this area over time, especially under a 10-year regulatory period.

Distribution of transmission charges

Murraylink propose to recover regulated revenue from South Australian and Victorian network users (passed through to end-users). Victorian users appear to bear a disproportionately large proportion of the costs but receive only a small proportion of the benefits. The major beneficiaries of Murraylink would be consumers in South Australia and generators in adjoining regions.

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We do not support the proposal and believe that costs need to be more closely aligned with benefits, which is entirely consistent with likely Code changes such as the 'beneficiary pays'.

Proposed regulatory period

Murraylink has proposed a regulatory period of 10-years. We note that this is at least double what the ACCC and other regulators normally permit.

We believe there would be advantages in requiring Murraylink to operate as a regulated interconnector with a similar regulatory period to that applied to other TNSPs. To do otherwise, would expose end-users to optimisation risks for a substantial period and may also encourage gaming of this issue in future.

If Murraylink is given a 10-year regulatory period, the ACCC should ensure that it has control over approving cost pass-throughs and additional scope to re-open Murraylink's regulatory determination to review if circumstances change.

We also note that within the proposed regulatory period it is quite possible that other interconnectors or alternative network augmentations could emerge which are more efficient than Murraylink. If that were the case and Murraylink becomes little used, it would be unacceptable for energy users to continue to pay for it as though it was more intensively used, as this would effectively become a subsidy. This supports the need for either a shorter regulatory period or scope to re-open the revenue determination.

Summary and Conclusions

Whilst the EUAA is not opposed to the concept of MNSPs, it believes that at this stage in the development of the NEM, customers' interests will be better served by regulated interconnectors and that the co-existence of MNSPs and TNSPs poses some vexed issues for the market and regulators. The EUAA also recognises that the Code permits MNSPs to apply to convert to regulated status and that the ACCC can apply considerable discretion in its treatment of such applications. We argue in this submission that the ACCC needs to use this application to define how it will treat conversion applications and use its discretion in future. The regulatory test, Code objectives, the Statement of Regulatory Principles, and the COAG principles on energy reform can be used to guide its approach to conversion.

We also express strong concern is that conversion may be used for commercial purposes by MNSPs; as a form of regulatory shopping or gaming. For example, they may switch status to overcome financial difficulties or to take advantage of prevailing market conditions, knowing that if an investment is not a commercial success they can apply to convert it to regulated status. The ACCC needs to ensure that its approach to conversion minimises such risks. We also argue for a 'once only' conversion option.

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There are several important issues for the ACCC to consider in relation to the Murraylink application.

First and foremost, the ACCC should only permit conversion on the basis of a rigorous analysis ensuring that customers benefit more than they do by either having Murraylink remain as an MNSP or from the alternatives to Murraylink.

Next, it is important for the ACCC to recognise that Murraylink's assets are sunk. As such its conversion to regulated status is worth somewhere between its scrap value and the replacement cost of the least cost option providing similar benefits. It has been calculated that Murraylink would operate at an additional 22MW under regulated status, which provides an approximation to its incremental benefit.

The Application also takes a narrow approach to determining alternative projects against which Murraylink is benchmarked. Several obvious alternatives are excluded, including demand management, generation and SNI. This has the impact of making Murraylink seem more attractive in terms of economic benefits than it actually is – something energy users would have to pay for. In addition, the choice of alternative projects with similar technical rather than economic benefits permits some front-loading of costs (eg undergrounding, additional transformers) which make Murraylink seem more attractive and adds to its RAV. Customers would be forced to pay for this through higher TUoS charges. It also claims additional benefits for provision of reactive support which the ACCC needs to clarify are acceptable for inclusion in the regulatory test. Benefits are also claimed for Riverland deferral, which ESIPC suggests are worth much less than claimed, possibly zero.

The ACCC must also ensure that Murraylink's peak capabilities are confirmed before it approves any conversion. There are unresolved issues concerning the actual technical capabilities of Murraylink, especially its transfer capacity during peak times (a critical matter for valuing its benefits).

Other apparent anomalies in the Application include the use of a WACC significantly higher than recently applied to other TNSPs, a commercial discount rate lower than that being applied to the regulatory test, the inclusion of as yet uncommitted investment and an apparent high level of spares. All these would add to the RAV.

SNI has been approved as a regulated link. Unless the courts overturn previous decisions, SNI would appear to have a clear path to construction. If this happens, end-users face a risk of having to pay for both Murraylink and SNI, even though this seems to involve needless duplication, with a potential combined RAV of up to \$300 million. This would be a severe and unjustified impost.

Our submission also raises concerns about the limited service standards proposed in Murraylink's Application. This includes an unchallenging reliability factor (97%) with the additional weakness of a $\pm 1\%$ 'dead band'

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around this, service incentives that are too blunt to be meaningful and a service standard regime that bears very little relationship to the energy market impacts of transmission outages. This approach makes Murraylink less attractive as a regulated link.

Our concerns also extend to the apparent desire to distribute the costs of a regulated Murraylink across end-users in both South Australia and Victoria. However, the main beneficiaries would seem to be users in South Australia and generators in South Australia and adjoining regions. We urge the ACCC to ensure that Victorian users only pay according to their benefits, consistent with likely amendments to the Code.

Finally, we question the need for a 10-year regulatory period for Murraylink given that other TNSPs operate under 5-year determinations and other undesirable aspects of such a long regulatory period.