NEW SOUTH WALES

MINISTER FOR ENERGY AND UTILITIES
MINISTER FOR SCIENCE AND MEDICAL RESEARCH
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MINISTER ASSISTING THE PREMIER ON THE ARTS

11 JUL 2003

Mr Graeme Samuel AO
Chairperson
Australian Competition and Consumer Commission
GPO Box 520J
MELBOURNE VIC 3001

Dear Mr Samuel

**ACCC PRELIMINARY VIEW ON MURRAYLINK CONVERSION APPLICATION**

I appreciate this opportunity to provide comments to the Commission in relation to its Preliminary View on Murraylink's application to convert to a regulated interconnect.

NSW can see no compelling reason for the ACCC's decision to allow Murraylink to earn a regulated income. There has been no change in the regulatory environment affecting the fortunes of unregulated interconnects that were not able to be considered at the time that the investment was made. There is no justification for protecting the investors of a bad commercial decision. Therefore, Murraylink investors should not have recourse to consumer funds if their project has simply been a commercial failure.

Regretfully, not only has the ACCC decided to grant Murraylink a regulated income, it has decided to offer a generous amount to the investors. Granted, this amount appears less than it cost the investors to build this project, but all this does is highlight the fact that the Murraylink investors made a poor commercial decision in the first place.

NSW believes that conversion of Murraylink would only be justified if there are benefits to consumers. This is only likely to happen if the asset value reflected the incremental benefits of the conversion. The ACCC's generous offer of between $115 and $120m looks significantly out-of-step with what could reasonably be expected.

As NSW has pointed out before, the incremental benefits of conversion are likely to be small. For example, Murraylink has previously argued publicly that they do not withdraw Murraylink's capacity to the market. If this is indeed the case, and if the only

Level 31, Governor Macquarie Tower, 1 Farrer Place, Sydney NSW 2000
Telephone: (02) 9228 4700 Facsimile: (02) 9228 4711 Email: office@sartor.minister.nsw.gov.au

thing that regulating Murraylink will change is to guarantee that its capacity will be made available to the market all the time, it stands to reason that any incremental benefit of regulation is likely to be small - certainly not large enough to justify the generous offer made by the ACCC to the investors of Murraylink.

Once again, NSW would urge the ACCC to look after the interests of electricity customers and base the regulated asset value on the incremental benefits of the conversion, which after all is the underlying principle of the ACCC's own Regulatory Test – a test that, ironically, the ACCC has misapplied in their Preliminary View.

Please contact Leisl Baumgartner in my office on 02 9228 4700 if you wish to discuss the NSW Government's submission.

Yours sincerely

Frank Sartor MP

MINISTRY OF ENERGY AND UTILITIES
NEW SOUTH WALES GOVERNMENT

# Submission to ACCC

# ACCC Preliminary View on Murraylink conversion application

July 2003

Ministry of Energy and Utilities
Level 6
Minerals and Energy House
29-57 Christie Street
ST LEONARDS NSW 2065

# Contents

# Executive Summary

## Introduction

The New South Wales (NSW) Minister for Energy (Minister) appreciates this opportunity to make a submission to the Australian Competition and Consumer ACCC (ACCC) on its Preliminary View regarding Murraylink's application for conversion to a prescribed service and a maximum allowable revenue for 2003-2012.

The Minister believes that the conversion of Murraylink to a regulated interconnect would only be justified if there are benefits to consumers. This is only likely to happen if the price of the asset reflects any additional benefits prodcued by the conversion from an unregulated to a regulated interconnect. The Minister believes that the ACCC's offer to the investors of Murraylink is uneccessarily generous and greatly exceeds any benefits likely to be produced from the conversion having regard to the fact that if Murraylink wasn't converted it would continue operating and Murraylink has stated previously that as an unregulated interconnect they do not deny their capacity to the market.

The NSW Minister believes that if the ACCC's Preliminary View stands, electricity customers will be worse off. The Minister therefore would request an urgent and independent review of the ACCC's decision.

## The Conversion Process

Clause 2.5.2(c) of the National Electricity Code (Code) gives the ACCC discretion to determine whether an unregulated interconnect should be converted to a regulated project and if so, to determine an appropriate asset value to be recovered from customers.

While the Code does not set out specific criteria for conversion of an unregulated interconnect to a regulated asset, the ACCC has attempted to provide a detailed rationale for its preliminary view that the conversion should be allowed.

However, this detailed rationale contains a number of errors of logic and fact that call into question the basis for the ACCC's approval of the conversion.

In its Preliminary View, the ACCC acknowledged the view of the National Electricity Code Adminstrators (NECA) "Safe Harbour" Working Group that conversion to a regulated interconnect should be available to unregulated interconnects where market design deficiencies adversely affected the regulatory regime covering unregulated interconnects. This was because the concept of non-regulated interconnectors was regarded by NECA and the ACCC as "somewhat experimental".

Importantly, the conversion option was explicitly not intended to shield unregulated interconnects from normal commercial risks. The clear implication behind this approach was that risks that affected other categories of National Electricity Market (NEM) participants would fall within the meaning of "normal commercial risks" and not justify conversion.

Murraylink and their consultants, the Allen Consulting Group (ACG), have attempted to exploit this provision in the Code by justifying the conversion of Murraylink

because, for example, the National Electricity Market Management Company (NEMMCO) approved TransGrid's South Australia-NSW interconnect (SNI). However, the SNI project was initially proposed as Riverlink in 1998, before Murraylink committed to building their project which commenced operation in October 2002. That is, Murraylink built their project knowing that TransGrid was committed to building its competing SNI project. In any case, SNI has yet to be built and therefore it cannot be said to have contributed to the financial woes of the Murraylink project. The ultimate construction of SNI can only be regarded as a commercial risk – not a regulatory risk

Similarly, Murraylink and the ACG argued that the "failure" of the ACCC to approve an increase in the market price cap to $20,000/MWh was another "regulatory risk" that adversely affected their project. However, this decsion affected all market participants, not just unregulated interconnects and therefore it cannot be said that this is a risk perculiar to unregulated interconnects.

The fact is that none of the arguments presented by Murraylink and the ACG proivide a convincing case for the conversion of Murraylink.

The ACCC's approach to conversion instead focussed on whether Murraylink exhibits the characteristics that are consistent with the definition of a "prescribed service", such that were it not for the unregulated interconnect provisions in the code, Murraylink would be a regulated interconnect. In considering whether Murraylink provides a "prescribed service", the ACCC asked whether Murraylink provides a "contestable" service – that is a service that could potentially be provided by a commercial agent in a normal market.

To test this, the ACCC defined the market as "the transfer of power into South Australia via an interconnector" and went on to discuss barriers to the entry of transmission interconnectors both generally and into South Australia. The ACCC concluded that Murraylink, as a commercial entity, would not be expected to build an unregulated interconnect. Thus, the ACCC concluded that Murraylink ought to be able to convert their project to a prescribed service, that is a regulated interconnect.

The ACCC's appraoch is deeply flawed in a number of respects.

First, if Murraylink does not provide benefits that are could be defined as 'contestable', it is not clear why the ACCC earlier rejected NSWs' proposal for the imposition of conditions that forced Murraylink to offer any spare capacity to the market – to prevent them from withholding capacity to maintain inter-regional price differences. The ACCC rejected the need for these conditions on the basis that the existence of several SA generators and the Heywood interconnector provided sufficient competition for Murraylink and limited Murraylink's ability to withhold its capacity. This approach reflected a view that unregulated interconnects provided similar services and faced similar incentives to generators in importing regions.

It is nonsensical for the ACCC to simultaneously hold the view that unregulated interconnects provide similar services as other contestable activities (i.e. generation) to avoid placing conditions on the authorisation of the assets at the same time arguing that unregulated interconnects ought to be considered a presecribed service because it would be unreasonable to expect a commercial entity to build an unregulated interconnect.

Similarly, in the ACCC's earlier authorisation of the Safe Harbour provisions, the ACCC rejected NSWs' view that the net public benefits of unregulated interconnects should be assessed in comparison to the obvious counterfactual – regulated interconnectors. In this context, NSW had argued that it was unlikely that unregulated interconnects provided any net public benefit over and above the counterfactual of not having unregulated interconnects, because if unregulated interconnects were not authorised, regulated interconnectors would be likely to be developed. Regulated interconnectors would not have the ability to restrict flows and so should lead to greater public benefits than unregulated interconnects. Rather, the ACCC conceded that whilst the unregulated interconnect provisions may not be consistent with optimal investment decisions – because the ACCC conceded they would have an incentive to restrict flows below socially optimal levels – unregulated interconnecs still offered public benefits:

> "...the ACCC considers that public benefits will arise from the increased competition and availability of electricity in the importing regions compared to the pre-existing circumstance where the market network services do not exist."

Now, in its Preliminary View, the ACCC has cited arguments made by Murraylink's consultants, the Allen Consulting Group, that benefits would flow from the conversion of Murraylink to a regulated project. These benefits would largely arise from the inability of Murraylink, as a regulated interconnect, to restrict flows on its link. These are precisely the same reasons that NSW had earlier relied upon in arguing against the authorisation of the Safe Harbour provisions and in favour of conditions to be placed on Murraylink's to ensure spare capacity is offered to the market. In other words, it appears that the ACCC has now accepted arguments for Murraylink's conversion that it had earlier rejected on two occassions in its authorisation of the Safe Harbour provisions and in its Murraylink access undertaking decision.

The Minister finds this inconsistency in the ACCC's regulatory approach disturbing. Most disturbing is the fact that these inconsistencies are not matters of fine argument but rather represent significant backflips.

The ACCC's difference in approach is associated with a different market definition. In its Preliminary View, the ACCC defined the market as "the transfer of power into South Australia via an interconnector", whereas in the access undertaking decision, the ACCC viewed the market as the entire South Australian region. No reason is given for these differing approaches, even though the fundamental economic question – the extent to which Murraylink's ability to sustainability earn economic profits is constrained by actual or potential competition – is the same.

It would seem the ACCC is prepared to adopt different definitions of the market, on the same matter, to suit their aims, whatever they may be.

Even if one accepts the ACCC's new market definition, the Minister disagrees that SNI would not provide effective competition to Murraylink. Clearly the Murraylink investors regard SNI as a competitive threat since they have attempted to hold up the project in whatever legal processes they can to frustrate the finalisation of the project.

The relevant question is not what competitors Murraylink would face if it were a regulated project, but what competitors it would face if it were ***not prescribed***. In this case, it is clear that if Murraylink did not convert to a regulated project, SNI – which

has been approved by both NEMMCO and the National Electricity Tribunal – would proceed and provide competition to a non-regulated Murraylink.

In the Minister's view, proponents of market-driven investments should not generally have the ability to convert to prescribed services. For example, generators do not have the ability to fall-back on a regulated income. However, the Minister believes that there are only two reasons why conversion could only be justified if:

- **there was an unforseeable change in the MNSP-specific regime** (as proposed by the NECA Working Group) – as we have highligted above, no such case has been made; and
- **consumers can benefit** – if the conversion results in more capacity or a price fall, or if customers can avoid costs, it is possible that conversion will result in some additional benefits to customers beyond those that have already resulted from its existence.

It is possible that some small additional benefit could result from the conversion of Murraylink to a regulated interconnect. However the Minister believes that the ACCC's offer to the investors of Murraylink is uneccessarily generous and greatly exceeds any benefits likely to be produced from the conversion having regard to the fact that if Murraylink wasn't converted it would continue operating and Murraylink has stated previously that as an unregulated interconnect they do not deny their capacity to the market.

Moreover, the Minister is disappointed that the ACCC has effectively offered Murraylink a free option to convert to a regulated interconnect at any time of their choosing. This option allows Murraylink to threaten to convert their project should any other project seek to provide benefits to customers. In this regard the ACCC has, perhaps unwittingly, aided in denying customers cheaper power. This oversight can be rectified simply by the ACCC seeking an immediate and irrevocable decision from Murraylink whether or not it wants to convert to a regulated interconnect.

**Initial Asset Valution**

The Minister's previous submission argued in favour of the "incremental benefits" approach to Murraylink's regulatory asset value. Under this approach, Murraylink would be valued at its expected return as an unregulated interconnect plus the efficient costs of obtaining the market benefits arising from its conversion to a regulated interconnect. The Minister also pointed out that in the SNI Tribunal hearing, Murraylink argued that this "incremental benefit" would be small or even negative due to Murraylink's likely bidding incentives.

However, in its Preliminary View, the ACCC rejected the incremental benefits approach fairly swiftly on the basis that it would not yield symmetry between the processes used by unregulated interconnects who apply for conversion and transmission augmentations proposed under Chapter 5 of the Code. The ACCC argued that treating Murraylink as if it were undergoing assessment under chapter 5 of the Code as a new regulated interconnector would yield outcomes that were more consistent with the Regulatory Test and with the ODRC valuation process the ACCC has endorsed in its Draft Statement of Regulatory Principles (the "symmetrical approach").

In the Minister's view, the approach to regulatory asset valuation should recognise the factor(s) that led to the conversion application.

When there are changes to regulation specific to unregulated interconnects, it is appropriate for the investor to receive the same return they would receive if the interconnector project were being developed as a regulated interconnector. This is because the investor's returns are being potentially undermined due to a risk that no other group of participants in the NEM faces. The ability to convert and receive a symmetrical treatment to a chapter 5 investment via a full ODRC regulatory asset valuation provides appropriate compensation for specific risks that unregulated interconnect investors and only unregulated interconnect investors face.

However, where there has simply been a change in commercial or general NEM regulatory conditions and the objective is just to avoid an inefficient outcome – as in Murraylink's case – unregulated interconnect investors should only be offered a regulated return equal to the additional economic benefits arising from the conversion. This is consistent with the key principle underpinning the Regulatory Test in the Code. This is because the rationale for conversion in this instance is not to compensate the unregulated interconnect investor for unregulated interconnect-specific risks, as discussed before, but to prevent a particular inefficient outcome from occurring. In this case, the incremental benefits approach should apply.

The ACCC's failure to distinguish between these sets of circumstances by applying a "symmetrical" approach regardless of the driver for conversion gives unregulated interconnects a strong advantage over generation and demand-side management options, which the ACCC has previously described as competitors to unregulated interconnects. This inequality of treatment was pointed out by a number of submittors to the ACCC's Murraylink Issues Paper.

In these circumstances, the incremental benefits approach promotes an efficient outcome in four ways.

First, it ensures that the unregulated interconnect investor is at least as well off as before the conversion application. This encourages the unregulated interconnect investor to seek conversion to avoid an inefficienct outcome.

Second, the incremental benefits approach minimises the competitive advantage that unregulated interconnects have over generators and demand side management projects.

Third, it recognises the actual economic decision before the ACCC – what net value does the market obtain through the decision to allow conversion of an unregulated interconnect to a regulated project. Economic analysis considers the impact of a decision on the margin – hence, economists' focus on marginal costs and benefits. Murraylink is a sunk investment, already bringing benefits to the market as an MNSP. The question raised by conversion is what *additional* benefits would flow to the market as a result of allowing the conversion to occur.

Fourth, as previously argued by the Minister, an incremental benefits approach ensures that all parties – Murraylink and the remainder of the market, including customers – benefit from the conversion decision. This implies a net economic benefit. By contrast, the use of the ACCC's symmetrical approach would not represent an economic improvement because it would make the position of customers worse off than if the conversion were not allowed.

In this context, the asset value allowed by the ACCC in its Preliminary View demonstrably fails to ensure that customers are not worse off as a result of the

conversion. If the conversion was not allowed, TransGrid would more than likely construct its original SNI project.

SNI would provide a firm 250MW import and export capability between NSW and SA at a capital cost of $110m. The project has been found by NEMMCO and the National Electricity Tribunal to provide net market benefits even with Murraylink in place as an unregulated interconnector.

By contrast, Murraylink, as a regulated interconnector:

- has lower absolute capacity – 200MW versus 250MW;
- has substantial constraints on its transfer capability and in fact requires upstream and downstream works (essentially "unbundled SNI") to give it firm capabilities; and
- has higher losses than SNI as a result of its DC technology.

However, the ACCC's Preliminary View gave this technologically inferior project a higher asset value of around $115m.

The ACCC further acknowledged that unbundled SNI or similar works should be constructed to allow Murraylink to transfer up to 220MW into SA. If this were to occur, then allowing an indicative capital cost for the upstream and downstream works of, say, around $60m, the total project cost for the combined regulated Murraylink and unbundled SNI would be some $175m.

The combined project would still be marginally less technically efficient than the original SNI (220MW versus 250MW and higher losses), but would have an asset value and thus an additional cost to end-use customers via transmission charges of $65m greater than SNI.

The ACCC needs to demonstrate either that some other economic efficiencies occur that justify this additional impost of $65m on customers or in its Final Determination reduce the asset value allowed for a regulated Murraylink so that customers are no worse off than if Murraylink had remained unregulated and the SNI project proceeded.

In fact on a dollar for MW basis, for a converted Murraylink project, combined with the upstream and downstream SNI works costing, say, around $60m, Murraylink ought not be valued more than $40m if customers are to be no worse off. This is signifcantly lower than the $115m offered by the ACCC.

In considering the asset value determined by the ACCC the results of an independent study commissioned by the NSW Treasury are noteworthy. NSW Treasury engaged Sinclair Knight Merz (SKM) to undertake an independent assesssment of the capital cost estimate for a functional equivalent proposed for Murraylink. SKM concluded that the approximate value of the functional equivalent to Murraylink is $72.5m. Importantly this value is generally consistent with the value that would be determined by the "incremental benefits" approach. Given the importance of this issue to the market generally, and to customers specifically, it behoves the ACCC to seriously consider the results of the SKM study. The SKM report is provided with this submission.

# 1 Introduction

The New South Wales Minister for Energy (Minister) appreciates this opportunity to make a submission to the Australian Competition and Consumer ACCC (ACCC) on its Preliminary View (Preliminary View) regarding Murraylink's application for conversion to a prescribed service and a maximum allowable revenue for 2003-2012 (Murraylink application).

In the Minister's February 2003 submission[1] to the ACCC in response to the ACCC's Murraylink Issues Paper[2], the Minister identified that conversion to a regulated interconnect would only be justified if there are benefits to consumers. In this context, the Minister wishes to make submissions on several important aspects of the ACCC's Preliminary View:

- the decision to allow Murraylink to convert to regulated status (section 2);
- the ACCC's view on the "incremental benefits" approach to Murraylink's regulatory asset value (section 3); and
- the ACCC's calculation of the optimised depreciated replacement cost (ODRC) of Murraylink (section 4).

The Minister's conclusions are in section 5.

In short, the Minister submits that the ACCC should:

- require Murraylink to immediately elect whether it chooses to undergo conversion to a prescribed service or not;
- adopt the incremental benefits approach to the regulatory asset valuation of Murraylink;
- concede that its original authorisation of market network service providers (MNSPs) was misconceived; and
- if it adopts a similar approach to the valuation of regular regulated augmentations, to base its regulatory cost of Murraylink on the basis of the likely costs of SNI.

[1] MEU, "Submission to ACCC, Murraylink Transmission Company application for conversion to a prescribed service and a maximum allowable revenue for 2003-12", February 2003 (Minister's earlier submission).
[2] ACCC, "Issues Paper, Murraylink Transmission Partnership, Application for Conversion to a Prescribed Service and a Maximum Allowable Revenue", February 2003 (Murraylink Issues Paper).

# 2 Conversion

## 2.1 Background

Clause 2.5.2(c) of the Code gives the ACCC discretion to determine whether a market network service (unregulated interconnect) should be converted to a prescribed service (regulated interconnect) and if so, to determine an appropriate revenue cap for the provision of those services.

While the Code does not set out specific criteria for conversion of an unregulated interconnect to a regulated service, the ACCC provided a detailed rationale for its Preliminary View that the conversion should be allowed.

However, this detailed rationale contains a number of errors of logic and fact that call into question the basis for approval.

## 2.2 NECA Working Group criteria for conversion

The ACCC began its Preliminary View by acknowledging that the intention of the NECA Working Group that developed the Safe Harbour provisions was to provide a right for unregulated interconnects to convert to regulated status where they experienced:

> "...additional risks related to market design deficiencies that may only become apparent once the first interconnectors are operational".[3]

This was because the concept of non-regulated interconnectors was still regarded as "somewhat experimental".[4]

Importantly it was stated that:

> "...it is important that the conversion option should not shield the proponent from normal commercial risks, eg the risk of having over-judged the future demand for the interconnection service."[5]

The clear implication of this approach was that risks that affected other categories of NEM participants more-or-less equally would fall within the meaning of "normal commercial risks" and therefore not provide a justification for conversion. This was essential to maintain competitive neutrality between unregulated interconnects and generators, which were regarded as potential competitors. Only risks that were primarily unregulated interconnect-specific would provide a rationale for conversion.

[3] Preliminary View, page 15.
[4] *Ibid.*
[5] *Ibid.*

Murraylink and its consultants the Allen Consulting Group (ACG) have tried to exploit this "escape clause" for unregulated interconnects and argued that a number of regulatory issues affecting unregulated interconnects had arisen that justified Murraylink's conversion. Both Murraylink and ACG accepted that Murraylink had to point to "non-commercial market design risks" to justify conversion of Murraylink to a prescribed service.[6] The types of issues that Murraylink and ACG raised are set out below.

**1) Murraylink's "non-commercial market design risks":[7]**

- uncertainty in relation to the interaction between the regulated and competitive sectors, in particular:
  - controversy over the SNI project; and
  - the South Australian ESIPC's view that a suitable network support agreement is required in conjunction with Murraylink to fully provide adequate network performance in the Riverland and to date no such agreement has been negotiated with Murraylink; and
- deficiencies identified in the Parer Report regarding the NEM, including:
  - confusion in energy governance arrangements;
  - perceptions of conflicts of interest;
  - flawed electricity transmission investment and operation; and
  - illiquid financial contracts market;

**2) ACG's "non-commercial market design risks":[8]**

- failure of the ACCC to approve an increase in VoLL to $20,000/MWh;
- failure of an increase in the number of NEM regions to be adopted; and
- failure of NEM to adopt 5 minute settlement.

It is clear from this list that Murraylink and its consultants were determined to show that unregulated interconnects had been hard done by but could point to nothing that could be regarded as a non-commercial market design risk that affected unregulated interconnects any more than other group of market participants. However, unregulated interconnect-specific regulatory risks are what must be demonstrated to justify conversion according to the NECA Working Group. After all, it was the "experimental" nature of the Safe Harbour regime for unregulated interconnects – not the evolving nature of the NEM's regulatory environment generally or changes in market conditions – that led the NECA Working Group to allow the conversion right for unregulated interconnects.

[6] Letter from S. Mailhot (Murraylink) to S. Roberts (ACCC), 8 April 2003, page 2 and ACG Report, page 7.
[7] Letter from S. Mailhot (Murraylink) to S. Roberts (ACCC), 8 April 2003, pages 2-3.
[8] ACG Report, pages 7-9.

Moreover, for market design issues to be "risks", the issues raised need to be unanticipated to a reasonable extent. It should not be sufficient for a unregulated interconnect developer to merely point to an alleged shortcoming in the market design that adversely affects them and which may have been reasonably obvious prior to their investment decision.

On this basis, going through Murraylink and ACG's list of issues:

- **SNI** – the assessment of the SNI project was always a commercial risk for Murraylink. SNI was proposed well before Murraylink was developed and Murraylink would have been aware that NEMMCO approval for Murraylink was a possibility, *particularly at the time Murraylink made its investment decision*;
- **SA ESIPC decision** – this was a specific network planning decision that did not change the overall regulatory environment for unregulated interconnects. Similar specific decisions are part and parcel of the environment for most energy market investment decisions;
- **Parer report** – this report simply identified issues that a number of NEM stakeholders have been concerned about for some time. It did not in itself create adverse regulatory outcomes for unregulated interconnects in particular. Moreover, the Parer Report is just one contribution to an ongoing commentary on the need for further reform in the energy market;
- **failure to increase the wholesale price cap** – this is an issue that affects all market participants, and arguably affects peaking generators more than unregulated interconnect. Moreover, there was never any assurance or undertaking by the ACCC or any other party that the wholesale price cap would be increased to $20,000/MWh. The price cap decision is an issue that market participants must take their own view. It is not an example of a "regulatory undertaking", where the regulator withdraws a commitment or takes a decision with direct impacts on a participant;
- **failure to increase the number of regions** – as with the price cap decision, this is a normal regulatory issue that potentially affects all market participants. Even assuming it was reasonable for Murraylink to have invested on the basis that more NEM regions would be formed (and it is very arguably not reasonable), it is not clear how the creation of such regions would have benefitted Murraylink; and
- **failure of NEM to adopt 5 minute settlement** – this again is an issue that affects all market participants and once again, no undertaking or assurance was or could have been given that such a change to the market design would be adopted.

## 2.3 ACCC's Preliminary View conversion criteria

The ACCC's Preliminary View does not attempt to assess whether the issues raised by Murraylink and ACG were non-commercial market design risks specific to unregulated interconnects. Had it done so, the Minister submits that the ACCC would have come to similar conclusions on each issue to those the Minister has outlined above. In fact, the Minister would argue that Murraylink successfully managed to avoid

being subjected to behavioural conditions on its Access Undertaking that could have required it to bid at a zero price differential.[9] Therefore, in the Minister's view, it could not be said that conversion of Murraylink could be justified on the basis of the original NECA Working Group's framework.

Rather, the ACCC focussed on whether Murraylink exhibits the characteristics that are consistent with the definition of a "prescribed service", such that were it not for the Safe Harbour provisions, it would be a prescribed service.[10]

It is not clear why the ACCC took this approach, given that the three reasons cited by the ACCC on page 15 of its Preliminary View appear to have nothing to do with the definition or meaning of a prescribed service. The clearest expression of why the ACCC focussed on the definition of prescribed service is in its discussion of Part B of chapter 6 of the Code, which provides that the ACCC is responsible for determining whether a given network service should be prescribed.[11] Presumably within this framework, if a service provided by an MNSP need not be prescribed, then the ACCC would reject a conversion application from that MNSP.

In any case, in considering whether Murraylink provides a prescribed sevice, the ACCC asked whether, *inter alia*, Murraylink provides a contestable service. The ACCC defined contestability as similar to the concept of "potential competition" and said that:

> "...regardless of the number of competitors, a market with 'effective competition' means that there is limited scope for a supplier to wield market power, and regulation is likely to be unnecessary."[12]

For this purpose, the ACCC defined the relevant market as "the transfer of power into South Australia via an interconnector"[13] and went on to discuss barriers to the entry of transmission interconnectors both generally and into South Australia. The ACCC noted that:

> "Substitutes for transmission into South Australia appear to be limited. While generation is an alternative option for increasing electricity supply, a generator does not provide similar technical services as an interconnector, and Murraylink in particular."[14]

The ACCC concluded that due to a lack of actual or potential competition, Murraylink could not be expected to be offered on a contestable basis.

The ACCC's analysis is problematic for a number of reasons.

**Inconsistency**

[9] See ACCC, "Access Undertaking, Murraylink Transmission Company, Decision", 6 November 2002 (Access Undertaking Decision).
[10] Preliminary View, pages 14-16.
[11] Preliminary View, page 16.
[12] Preliminary View, page 18.
[13] Preliminary View, page 19.
[14] Preliminary View, page 19.

In its Preliminary View, the ACCC went to great lengths to demonstrate that Murraylink faces few potential competitors. However, if the ACCC believes Murraylink provides services that are not easily contestable, it is not clear why the ACCC previously allowed Murraylink to proceed as an unregulated interconnector without any conditions in the first instance.

More particularly at the time of the Access Undertaking Decision, the ACCC explicitly rejected NSWs' suggestion that condiutions be placed on Murraylink that prevented them from withholding their capacity from the market (so called "Neptune" conditions). The ACCC rejected imposing these conditions on Murraylink's Access Undertaking on the basis that Murraylink's conduct was sufficiently constrained by other market participants – that is, Murraylink was operating in the context of a competitive market. The ACCC took the view that:

> "Given that MTC will act in a manner similar to a generator in the importing region, existing generators in South Australia represent the primary competitive constraints against the way that Murraylink is bid into the NEM."[15] and

> "...prima facie, the existence of several large generators and an alternate, larger, interconnector competing within the South Australian region is likely to substantially constrain MTC, as a stand -alone entity, from withholding Murraylink's capacity from the NEM."[16]

Similarly, in the ACCC's earlier authorisation of the Safe Harbour provisions, the ACCC compared unregulated interconnects to generators and rejected NSWs' view that the net public benefits of unregulated interconnects should be assessed in comparison to the obvious counterfactual – regulated interconnectors. Explaining this point properly requires review of the relevant submissions and decisions:

In the ACCC's Draft Determination on Network Pricing and MNSPs[17], the ACCC conceded that the unregulated interconnect provisions may not be consistent with optimal investment decisions:

> "...the ACCC recognises that the incentive placed on the proponents of a market network service will be to preserve price differentials between regions, either by constructing a link of smaller than socially-optimal capacity and/or by restricting flows between the regions. Further an MNSP may bid its capacity into the NEM at high prices, though such strategies will be constrained by the bid prices of competing generators and interconnectors. As such the MNSP will possess a degree of market power and may be able to influence spot prices, especially by withdrawing capacity from the spot market."[18]

Nevertheless, the ACCC believed that public benefit could flow from the introduction of unregulated interconnects:

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[15] Access Undertaking Decision, page 23.
[16] Access Undertaking Decision, pages 23-24.
[17] ACCC, "Network pricing and market network service providers", 12 December 2000 (Draft Determination on Network Pricing and MNSPs).
[18] Page 97.

> "Thus while it is clear that the proposed arrangements may be sub-optimal, the ACCC considers there will be increased availability of electricity in the importing regions compared to the pre-existing circumstances where the market network services do not exist."[19]

In a submission to the ACCC's Draft Determination on Network Pricing and MNSPs, the NSW Treaury argued that:

> "It is worth examining the counter-factual situation if the MNSP provisions were not authorised. The counter-factual is not necessarily that no additional availability of electricity in importing regions would occur without MNSPs. Rather, without MNSPs being able to game the regulatory test by posing as committed or anticipated projects when they are best tentative, the absence of MNSPs could enhance the prospects of proposed regulated links passing the regulatory test. It is widely accepted that regulated links are more likely to be socially optimal in size than market links. Therefore, the counter-factual to the authorisation of the MNSP provisions could actually be greater competition for generators in importing regions and hence more efficient market outcomes in the long run. Therefore, MIG does not believe that the ACCC has made a clear public benefit case for the authorisation of MNSPs on the present terms."[20]

In its Final Determination on Network Pricing and MNSPs, the ACCC nevertheless found that MNSPs offered public benefits:

> "The ACCC believes that market network services will provide a source of competition for generators in an importing region and that investment and bidding decisions are likely to face similar incentives. Further, the ACCC notes that where market network services are constructed the risks and costs associated with the investment fall upon the proponents of the service, rather than customers and TNSPs, as is the case with regulated investments. Thus the ACCC considers that public benefits will arise from the increased competition and availability of electricity in the importing regions compared to the pre-existing circumstance where the market network services do not exist."[21]

The implication of this passage and later passages in the ACCC's Final Determination is that the ACCC generally likened the services provided, and the incentives faced, by unregulated interconnects to those of generators in an importing region.

The ACCC did not directly compare the public benefits of unregulated interconnects with the public benefits of the obvious alternative to unregulated interconnects – regulated interconnectors – as the NSW Government had suggested the ACCC should do. The ACCC thereby failed to acknowledge that in most circumstances, if an unregulated

[19] Draft Determination on Network Pricing and MNSPs, pages 97-98.
[20] Letter from D. Anderson (NSW Treasury) to M. Rawstron (ACCC), "Submission on ACCC Network Pricing Draft Determination", April 2001, page 5.
[21] ACCC, "Network pricing and market network service providers", 21 September 2001 (Final Determination on Network Pricing and MNSPs), pages 132-133.

interconnect was not developed, a free-flowing regulated interconnector would be developed. Had it made this comparison at the time the ACCC examined the Safe Harbour provisions, the Minister submits that the ACCC would have found that unregulated interconnects generally did not confer net public benefits to the market against the obvious counterfactual scenario of a regulated interconnector.

Now, in its Preliminary View, the ACCC has accepted that the conversion of Murraylink to a regulated interconnector would offer net public benefits. The ACCC cited arguments made by Murraylink's consultants, the ACG that:

> "1. Murraylink's conversion to a regulated interconnector would remove any incentive or ability to withhold its capacity from the market, and so preclude any such inefficiency; and
>
> "2. Operating Murraylink on an open-access basis may also provide for a more certain environment for the planning of the national electricity grid. ACG states that this reflects the fact that all of Murraylink's capacity (subject to relevant constraints) would be available for the independent operator to use as the system dictates rather than the available capacity being determined by MTC's bidding behaviour."[22]

The ACCC went on to state:

> "The increased efficiency in the way that Murraylink is provided to the market will benefit electricity suppliers upstream and downstream of Murraylink, and subsequently, all users of those services."[23]

The Minister is confused and frustrated by the ACCC's apparent about-face. It appears that when the NSW Government makes an argument – that unregulated interconnects do not provide net benefits over the counterfactual of regulated interconnectors – it is dismissed or ignored by the ACCC, but when Murraylink or its consultants make precisely the same argument, the ACCC quotes the argument with approval and basis its "Preliminary View" on that same argument.

The ACCC has effectively gone from a view that Murraylink competes with generators in the importing region to a view that transmission is a unique service that should not be compared with generation. Closely associated with the change in the ACCC's views on the service offered by Murraylink is the change in the relevant market being examined by the ACCC.

As noted by Mason CJ and Wilson J of the High Court in the *Queensland Wire* decision[24]:

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[22] Preliminary View, page 22. See also, ACG, "Application for Conversion of Murraylink to a Prescribed Service: Commentary on the Economic Issues", April 2003 (ACG Report), pages 4-5.

[23] Preliminary View, page 22.

[24] *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989) 167 CLR 177 (*Queensland Wire*).

> "Defining the market and evaluating the degree of power in that market are part of the same process, and it is for the sake of simplicity of analysis that the two are separated. ...too narrow a description of the market will create the appearance of more market power than in fact exists; too broad a description will create the appearance of less market power than there is..."[25]

The ACCC's view of the relevant market appears to have changed from the Access Undertaking Decision – when it was the entire South Australian region – to the much narrower market in the Preliminary View of "the transfer of power into South Australia via an interconnector". No reason is given for these differing approaches even though both the definition of contestability used by the ACCC in its Preliminary View and the ACCC's market power analysis in its Access Undertaking Decision fundamentally examine the same issue – the extent to which Murraylink's ability to sustainably earn economic profits is constrained by actual or potential competitors.

**Incorrect characterisation of market**

Even if one accepts the ACCC's new market definition for assessing the market power of Murraylink, the Minister disagrees with the ACCC's view that SNI would not be a viable competitor to Murraylink.[26] The ACCC said that if Murraylink were regulated, it would not face competition from SNI for a variety of reasons and concluded that:

> "The relevant question arising from this analysis is whether it would be economic to develop ***another regulated interconnector*** in this area. As noted, the ACCC expects that this would be unlikely."[27] [emphasis added]

However, the Minister submits that the ACCC has incorrectly posed the "relevant question". The question is not whether a second regulated interconnector would be viable in light of Murraylink's conversion to a prescribed service. The relevant question – according to the ACCC's framework – is whether sufficient actual or potential competition to Murraylink exists for regulation of Murraylink to be unnecessary. The question the ACCC is asking is whether Murraylink faces sufficient competition to not be regulated rather than whether Murraylink would be duplicated by another regulated interconnector if it converted to a prescribed service.

Therefore, the prospects of SNI must be examined on the basis that Murraylink is not a prescribed service. In this case, it is clear that SNI – having been approved by both NEMMCO[28] and the National Electricity

[25] *Queensland Wire*, page 187, as reproduced in Miller, R.V., "Miller's Annotated Trade Practices Act 1974", 24th Edition, Lawbook Company 2003, page 97.
[26] Page 20.
[27] Preliminary View, page 20.
[28] NEMMCO, "Determination Under Clause 5.6.6 of the Code – SNI Option", 6 December 2001.

Tribunal[29] as maximising net benefits on the assumption that Murraylink is a "committed" unregulated interconnect project – would most probably go ahead. Hence, even on the basis of the ACCC's new restrictive market definition approach, Murraylink as a non-prescribed service would likely face an effective competitior in a regulated SNI.

**Minister's Commentary**

The Minister finds it puzzling that the ACCC appears to have changed its view on the nature of the service offered by Murraylink (and the appropriate market definition) by such a degree within a six month period. The ACCC's approach appears to be an *ex post* rationalisation of its view that Murraylink should be allowed to convert to a prescribed service without having to demonstrate a change in MNSP-specific regulation in accordance with the NECA Working Group criteria that have been acknowledged and accepted by Murraylink itself (see section 2.1 above).

As the Minister noted in his submission on the Murraylink application in February 2003, the key underlying issue the ACCC is unsuccessfully grappling with is the nature of transmission – to what extent is transmission a substitute for generation and demand-side management (DSM) and to what extent does it provide a more unique, pro-competitive "market connectivity"-type service. The ACCC's failure to explicitly acknowledge this conundrum is what is driving its inconsistent approach from one decision to the next.

In this context, the Minister proposes that the ACCC refrains from trying to characterise the relevant market that Murraylink operates in or whether or not Murraylink offers a service that would be prescribed but for the Safe Harbour provisions. The ACCC has already made a previous Decision on the Murraylink Access Undertaking that implies that it views transmission as primarily a substitute for generation and hence that Murraylink faces sufficient competition to avoid the need for any substantive price or conduct regulation. It is inapproriate and confusing for the ACCC to switch to the view that the transmission service offered by Murraylink is now virtually a unique service that should be analysed within the confines of a separate market for electricity transmission into South Australia.

Instead, the Minister submits that the ACCC should focus on developing a logical link between the circumstances of Murraylink conversion application and the appropriate regulatory asset value of Murraylink as a prescribed service. The Minister's proposal for how this link should be made is discussed below.

[29] National Electricity Tribunal, "Application No. 1 OF 2001 in the matter of an application for review of a NEMMCO determination on the SNI interconnector dated 6 December 2001, Reasons for Decision", 24 October 2002.

## 2.4 Minister's conversion criteria

As stated in the Minister's submission on the ACCC's Murraylink Issues Paper, the Minister believes that as a general principle, proponents of market-driven investments should not have the ability to convert to regulated status. The key salutary effect of markets is that they enable profit and loss incentives to guide efficient decision-making. This is why generators do not have an ability to fall-back on a regulated income. Indeed, both the ACCC and Murraylink have previously argued that:

- MNSPs and generators in importing regions offer broadly equivalent services and face similar incentives on how they bid capacity;[30] and that
- one of the key benefits of MNSPs is that that investors (rather than customers) bear the *full* risks of their investment.[31]

This suggests that, *prima facie*, if generators are not able to convert to regulated services regardless of the market benefits they provide, unregulated interconnects also should not have this ability.

Nevertheless, the Minister believes that conversion to a regulated interconnect is only justifiable if:

- there is a change in the unregulated interconnect-specific regulatory arrangements that undermine the projects; and
- there are benefits to customers – if conversion results in more capacity or if prices decline, or if customers can avoid costs, it is possible that conversion will result in some additional benefits to customers.

### 1) Change in the MNSP-specific regulatory regime

As argued by the NECA Working Group and implicitly accepted by Murraylink, a change in the MNSP-specific regulatory framework may warrant special treatment of MNSPs. However, as discussed above, in the case of Murraylink's application, such adverse outcomes have plainly not occurred. The Safe Harbour provisions have not been materially changed since they were first authorised and the ACCC placed no conditions on Murraylink's Access Undertaking that could be regarded as compromising Murraylink's ability to earn a commercial return (notwithstanding the fact that the ACCC now appears to believe that Murraylink faces few actual or potential competitors).

[30] See ACCC, Final Determination on Network Pricing and MNSPs, pages 131-133; ACCC, Access Undertaking Decision, page 23; TransEnergie Australia Pty Ltd, "Network Pricing and Market Network Services", 12 April 2001, (TransEnergie submission to ACCC on Draft Determination on Network Pricing and MNSPs), page 12; Witness Statement of Anthony Steven Cook (Murraylink Transmission Company) in the National Electricity Tribunal, 14 May 2002 (A Cook Witness Statement), paragraph 41, page 23.

[31] See ACCC, Final Determination on Network Pricing and MNSPs, pages 131-133; TransEnergie submission to ACCC on Draft Determination on Network Pricing and MNSPs pages 11-14; A Cook Witness Statement, paragraph 44, pages 23-25.

### 2) Benefits to customers

Where it can reasonably be shown that there are additional benefits to customer by converting a project from an unregulated project to a regulated project, it *may* be appropriate to allow conversion.

In the case of Murraylink, this second justification *may* be applicable, provided the regulated asset base is appropriate. However, the Minister would be quick to point out that regulatory intervention is not justified in all such occassions. After all, regulators do not (and should not) habitually intervene in markets simply because a particular inefficient outcome may result from non-intervention.

The appropriate value of conversion is discussed in section 3 below.

## 2.5 Optionality of conversion

In the Minister's earlier submission, the Minister argued that if Murraylink is permitted to convert to prescribed status, then having made a conversion application, Murraylink should not have an option to go through with the conversion or not.[32] Allowing such an option would allow Murraylink to "game" the ACCC by threatening not to convert unless it was offered a high enough regulatory value. It is clear that the ACCC is very keen to prevent such duplication and that Murraylink would be aware of the ACCC's position in this regard.

Unfortunately, the ACCC's approach of offering a "Preliminary View" on the conversion application, complete with indicative regulatory asset value, does exactly what the Minister suggested was unwise. In combination with the extremely generous regulatory asset value the ACCC has offered, the weight of evidence suggests that the ACCC is trying to entice Murraylink to take the conversion option in order to avoid the network duplication that might follow from Murraylink remaining an unregulated interconnect. The Minister suggests that the market as a whole – namely, end-use customers – will pay the price of the ACCC's attempts to entice Murraylink in this manner.

A far better approach would have been for the ACCC to only accept Murraylink's application on the condition that it was irrevocable and the ACCC's decision on regulatory asset value was binding. This would not only have streamlined the conversion process, but it would have allowed the ACCC to regulate Murraylink with the same bargaining power it has over regulated transmission network service providers in the NEM.

In the present context, the Minister suggests that the ACCC write to Murraylink requesting that Murraylink make an immediate and irrevocable decision whether or not to convert to a prescribed service. This decision should be made by Murraylink and acknowledged by the ACCC before the ACCC publishes any further views on the Murraylink application.

[32] Pages 5-6.

# 3 Incremental benefits approach

## 3.1 ACCC's Preliminary View

In terms of ascertaining the appropriate regulatory asset value of Murraylink, the Minister in his earlier submission supported what the ACCC has termed the "incremental benefits" approach.[33] Under this approach, Murraylink would be valued at its expected return as an unregulated interconnect plus the market benefits arising from its conversion to a regulated service. The Minister also pointed out that in the SNI Tribunal hearing, Murraylink argued that this "incremental benefit" would be small or even negative due to Murraylink's likely bidding incentives.[34]

However, in its Preliminary View, the ACCC rejected the incremental benefits approach fairly swiftly on the basis that it would not yield symmetry between the processes used by unregulated interconnects who apply for conversion and transmission augmentations proposed under Chapter 5 of the Code. The ACCC argued that treating Murraylink as if it were undergoing assessment under chapter 5 of the Code as a new regulated interconnector would yield outcomes that were more consistent with the Regulatory Test and with the ODRC valuation process the ACCC has endorsed in its Draft Statement of Regulatory Principles.[35]

The ACCC's approach to Murraylink's regulatory asset value is referred to as the "symmetrical approach" in the remainder of this submission.

## 3.2 Minister's view

**The "symmetrical approach"**

In the Minister's view, the approach to regulatory asset valuation should recognise the factor(s) that led to the conversion application. Whilst it may be desirable for unregulated interconnect investors to receive symmetrical treatment to new regulated interconnectors where a change in the unregulated interconnect-specific regulatory regime has occurred – such as a material adverse change to the Safe Harbour provisions or onerous Access Undertaking conditions – it is not desirable for unregulated interconnect investors to receive such treatment where a mere change in commercial conditions or the general NEM regulatory environment has occurred.

When there are changes to unregulated interconnect-specific regulation, it is appropriate for the investor to receive the same return that they would receive if the interconnector project were being developed as a regulated interconnector. This is because the investor's returns are being

[33] Pages 14-18.
[34] Minister's earlier submission, pages 15-17.
[35] Preliminary View, pages 23-24.

potentially undermined due to a risk that no other group of participants in the NEM faces. The ability to convert and receive a symmetrical treatment to a chapter 5 investment via a full ODRC regulatory asset valuation provides appropriate compensation for specific risks that unregulated interconnect investors and only unregulated interconnect investors face.

However, where there has simply been a change in commercial or general NEM regulatory conditions and the objective is just to avoid an inefficient outcome, unregulated interconnect investors should only be offered a regulated return high enough to promote such an efficient outcome. This is because the rationale for conversion in this instance is not to compensate the unregulated interconnect investor for unregulated interconnect-specific risks, as discussed before, but to prevent a particular inefficient outcome from occurring. In this case, the unregulated interconnect investor should only be offered a regulatory return to compensate for foregone returns from being an unregulated interconnect, as well as the ODRC of the *additional* capacity made available by the conversion. This amounts to the incremental benefits approach.

The ACCC's failure to distinguish between these sets of circumstances by applying a "symmetrical" approach regardless of the driver for conversion leads to severe problems in maintaining its view on the economic equivalence between unregulated interconnects and generators.

**MNSP advantage over generators**

The ACCC has previously noted similarities between unregulated interconnects and generators in an importing region.

In fact, as discussed in section 2.3 above, when authorising the Safe Harbour provisions, the ACCC did not compare the net benefits of unregulated interconnects against regulated interconnectors (which would have shown unregulated interconnects to be net detrimental), but instead compared unregulated interconnects to generators in an importing region.

The ACCC argued that unregulated interconnects would provide a public benefit by providing competition to such generators.[36] In a number of other respects – incentives to underbuild, to withhold capacity and to exercise market power through bidding and rebidding – the ACCC drew parallels between unregulated interconnects and generators.[37] Further, in the Murraylink Access Undertaking Decision, the ACCC found that Murraylink's ability to withhold its capacity would be attenuated by the existence of the South Australian generators, again suggesting that unregulated interconnects and generators are substitutes and hence competitors.[38]

[36] ACCC, Final Determination on Network Pricing and MNSPs, pages 131-132.
[37] *Ibid.*
[38] Access Undertaking Decision, pages 22-24.

In this context, allowing Murraylink to convert to regulated status at a regulatory asset value that is the same as would be achieved under chapter 5 effectively provides all unregulated interconnects with a free option to convert to prescribed status at a full ODRC asset valuation, even though no unregulated interconnects-specific reasons underlie the conversion application. This would give unregulated interconnect proponents a clear advantage over developers of merchant generation or DSM projects, who do not have the option to fall back on a regulated income when market circumstances or general NEM regulation changes, much less at a full ODRC valuation.

This inequality of treatment was pointed out by Edison Mission Energy, Integral and other submittors to the ACCC's Murraylink Issues Paper.[39] Other things being equal, under the ACCC's approach, an investor would prefer to invest in an unregulated interconnects than a generator. This could not be considered efficient in the context of the ACCC's earlier paradigm of the economic equivalence of generators and unregulated interconnects. Presumably the ACCC would not want to tilt investment towards one asset class over another.

**Benefits of incremental benefits approach**

As noted above, the Minister understands that the conversion of Murraylink may still be net beneficial. In this context, the Minister submits that where there has not been a material change in the unregulated interconnect regulatory regime, it would be appropriate to apply the incremental benefits approach.

In these circumstances, the incremental benefits approach promotes an efficient outcome in four ways.

First, it ensures that the unregulated interconnect investor is at least as well off as before the conversion application. This encourages the unregulated interconnect investor to seek conversion, which in turn promotes an efficient outcome if duplication is the counterfactual if the conversion is not allowed.

Second, the incremental benefits approach minimises the competitive advantage that unregulated interconnects have over generators and DSM projects.

Third, it recognises the actual economic decision before the ACCC – what net value does the market obtain through the decision to allow conversion of an unregulated interconnect to a regulated service. Economic analysis considers the impact of a decision on the margin – hence, traditional economics' focus on marginal costs and benefits. Murraylink is a sunk investment, already bringing benefits to the market as an unregulated interconnect.

The question raised by conversion is what *additional* benefits would flow to the market as a result of allowing the conversion to occur. To put this question in the language of the Regulatory Test and to show how the

[39] Preliminary View, page 11.

incremental benefits approach is consistent with the Regulatory Test, Murraylink as an unregulated interconnect can be characterised as already being part of the "base case market development scenarios". The "project" effectively being assessed through the conversion process for the purposes of the Regulatory Test is just the *additional capacity that would flow from the conversion decision*. Consequently, the economic issue underlying Murraylink's conversion is the impact of its conversion on gross market benefits. This is a different question to whether it would be net beneficial to develop Murraylink as a regulated interconnector today.

Fourth, as previously argued by the Minister, an incremental benefits approach ensures that the remainder of the market – ie customers – do not suffer due to the decision to allow Murraylink to convert.[40] In light of the fact that in the present case, the conversion is being allowed even though no unregulated interconnect-specific risks were involved, it would appear to be appropriate for customers not to suffer from Murraylink's conversion. Indeed, the incremental benefits approach allows all parties – Murraylink and the remainder of the market, including customers – to benefit from the conversion decision. This implies a net improvement in welfare. By contrast, the use of the ACCC's symmetrical approach would not represent a net improvement in welfare since it would make the position of customers worse off than if the conversion were not allowed.

[40] Minister's earlier submission, pages 14-17.

# 4 Symmetrical valuation of Murraylink

If, despite the arguments in the previous section, the ACCC rejects the incremental benefits approach, the Minister wishes to make a number of points regarding the ACCC's "symmetrical approach" to Murraylink's regulatory asset valuation.

It should be noted that if Murraylink's conversion to a regulated service were not allowed, TransGrid would be likely to construct its proposed SNI project.

That project would provide a firm 250MW import and export capability between NSW and South Australia at a capital cost of $110m. The project has been found by NEMMCO and the National Electricity Tribunal to provide net market benefits even with Murraylink in place as an unregulated interconnector.[41]

By contrast, Murraylink, as a regulated interconnector:

- has lower absolute capacity – 200MW versus 250MW;
- has substantial constraints on its transfer capability and in fact requires upstream and downstream works (essentially the project known as "unbundled SNI") to give it firm capabilities; and
- has higher losses than SNI as a result of its DC technology.

However, the ACCC's Preliminary View, gives Murraylink a higher asset value of $115m.

The ACCC further acknowledges that unbundled SNI or similar works should be constructed to allow Murraylink to transfer 220MW into South Australia. If this were to occur, then allowing an indicative capital cost for the upstream and downstream works needed of, say, around $60m, the total project cost for the combined regulated Murraylink and unbundled SNI would be $175m.

The combined project would still be marginally less technically efficient than the proposed SNI project (220MW versus 250MW and higher losses), but would have an asset value and thus an additional cost to end-use customers via transmission charges of $65m greater than SNI.

The ACCC needs to either demonstrate than some other economic efficiencies would arise that justify this additional impost of $65m on customers or it should reduce the asset value allowed for a regulated Murraylink in its Final Determination so that customers are no worse off than if Murraylink had remained unregulated and the SNI project proceeded. On a dollar for MW basis, for a converted Murraylink project, combined with the upstream and downstream works costing, say, $60m, Murraylink ought not be valued more than $40m if customers are to be no worse off.

[41] NEMMCO, "Determination Under Clause 5.6.6 of the Code – SNI Option", 6 December 2001; National Electricity Tribunal, "Application No. 1 OF 2001 in the matter of an application for review of a NEMMCO determination on the SNI interconnector dated 6 December 2001, Reasons for Decision", 24 October 2002.

In considering the asset value determined by the ACCC the results of an independent study commissioned by the NSW Treasury are noteworthy. NSW Treasury engaged Sinclair Knight Merz (SKM) to undertake an independent assesssment of the capital cost estimate for a functional equivalent proposed for Murraylink. SKM concluded that the approximate value of the functional equivalent to Murraylink is $72.5m. Interestingly, this value is more consistent with the value that would be determined by the "incremental benefits" approach. Given the importance of this issue to the market generally, and to customers specifically, it behoves the ACCC to seriously consider the results of the SKM study. The SKM report is attached to this submission.

Incidentally, using the existing basis for sharing of interconnect transmission costs between the various States, the bulk of additional costs attributed to the combined unregulated Murraylink and unbundled SNI as conceived by the ACCC in their Preliminary View fall on Victorian customers and, to a lesser extent, South Australian customers.

# 5 Conclusion

In this submission, the Minister has argued that:

- the Minister believes Murraylink's conversion is only justified if there are additional net benefits from doing so. Further, the Minister believes that the maximum regulatory value that could assigned would be the size of these net benefits;
- in accordance with the NECA Safe Harbour Working Group's criteria, Murraylink and its consultants acknowledged the need to demonstrate a change in the non-commercial market design environment to justify conversion;
- no material change in the MNSP-specific regulatory framework has occurred since Murraylink's investment decision;
- the ACCC's assessment of the "prescribed service" characteristics of Murraylink, focussing on whether Murraylink faced actual or potential competition in the *transportation of power to South Australia*, is inconsistent with the position it took in the Murraylink Access Undertaking Decision, due in large part to the different market definition it adopted;
- the ACCC's finding that the conversion of Murraylink to a prescribed service would yield net benefits is also inconsistent with its previous finding – implicit in its authorisation of the MNSP Safe Harbour provisions – that MNSPs provide net public benefits;
- the ACCC should avoid attempting to redefine the nature of transmission and concentrate on finding an appropriate regulatory asset value for the conversion;
- the ACCC's rejection of the incremental benefits approach and adoption of the "symmetrical approach" to valuation may be appropriate in some cases – where there has been a significant change in MNSP-specific regulation. This is because in such cases conversion is designed to compensate investors for MNSP-specific risks;
- however, where there has only been a change in general market conditions or the overall NEM regulatory environment, it is not appropriate to underwrite the value of MNSPs in this way because of the favourable treatment it implies for MNSPs over generators;
- the incremental benefits approach ensures:
    - efficient outcomes;
    - no favourable treatment for unregulated interconnects over generators;
    - correct characterisation of the economic decision to be made; and
    - both customers and Murraylink benefitting from the conversion (i.e. Pareto improvements in welfare).

- if the ACCC rejects the incremental benefits approach and applies its symmetrical approach, it should recognise that the costs of SNI are substantially less than the regulatory cost it has provisionally allowed for Murraylink;
- therefore, the ACCC needs to demonstrate either than some other economic efficiencies occur that justify this additional impost of some $65m on customers, or reduce the asset value allowed for a regulated Murraylink in its Final Determination so that customers are no worse off than if Murraylink had remained unregulated and the SNI project proceeded;
- independent analysis conducted by Sinclair Knight Merz found that the approximate value of the functional equivalent to Murraylink is $72.5m. This value is more consistent with the value that would be determined by the "incremental benefits" approach.
- finally, the ACCC has effectively allowed Murraylink an "option" to convert, which is likely to lead to regulatory gaming that is costly for the remainder of the market. Murraylink should now be required to immediately and irrevocably decide whether it will convert to a prescribed service.