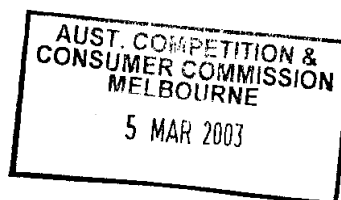




New South Wales

MINISTER FOR INFORMATION TECHNOLOGY,  
MINISTER FOR ENERGY, MINISTER FOR FORESTRY, AND  
MINISTER FOR WESTERN SYDNEY



FILE No: M2002/468-06
DOC: 503/9032
INSTRUM: 16102.

Professor Alan Fels  
Chairman  
Australian Competition and Consumer Commission  
GPO Box 520J  
MELBOURNE 3001

27 FEB 2003

Dear Professor Fels

### **MURRAYLINK APPLICATION FOR CONVERSION TO PRESCRIBED SERVICE**

The NSW Government is concerned about Murraylinks application for regulated status. If successful, this development would seriously compromise the arrangements in the National Electricity Market.

The NSW Government cautioned that the right for market network service provider's (MNSP's) to convert to regulated status would be used to underpin the poor commercial decisions of MNSP's and stifle the development of other genuinely beneficial interconnection projects.

If successfully employed in this and other instances, these safe harbour provisions will continue to be exploited to the detriment of electricity customers. This is particularly seen in the case of South Australia where customers have been denied access to cheap power from other States. As a consequence, prices for small customers have now risen by 30%. This and the failure to achieve the key aim of the NEM – to promote interconnection – raise fundamental issues about the effectiveness of the market to deliver real outcomes for customers.

Murraylink has consistently derided regulated interconnects, promoting the superiority of their own project because it did not impose costs or risks on customers. For Murraylink to now seek, and be allowed, regulated status would set an undesirable precedent and provide poor incentives for future investment in the market

Murraylink has been one of the strongest advocates of a free market approach to the development of the transmission system. Given Murraylinks wholehearted support for the operation of a free market in the transmission system, the NSW Government believes that they should experience the full effect of market outcomes rather than enjoying the protection of a regulator.

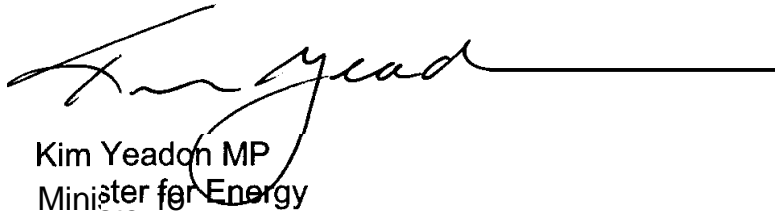
Level 36 Governor Macquarie Tower  
1 Farrer Place, Sydney NSW 2000  
Phone (02) 9228 3688 Fax (02) 9228 3801  
Email: kim.yeadon@it.nsw.gov.au

Murraylink's application for regulated status presents an important test of the regulatory framework and its application. If the ACCC grants regulated status to Murraylink, the ACCC will have effectively underpinned the profits of a failed commercial venture - a move that the ACCC has avoided in other industries, such as airlines.

NSW believes if the regulatory test were conducted properly, Murraylink would only receive a small fraction of the costs that they have claimed. The NSW Government urges the ACCC to carefully consider the points made in the attached submission.

I am keen to discuss this matter with you further. In this regard, please contact my Chief of Staff, Ms Leisl Baumgartner, on (02) 9228 3688 to make the necessary arrangements.

Yours sincerely

A handwritten signature in black ink, appearing to read "Kim Yeadon", followed by a horizontal line extending to the right. The signature is written in a cursive style.

Kim Yeadon MP  
Minister for Energy



**MINISTRY OF ENERGY AND UTILITIES**  
NEW SOUTH WALES GOVERNMENT

## **Submission to ACCC**

**Murraylink Transmission  
Company application for  
conversion to a prescribed  
service and a maximum  
allowable revenue for  
2003-12**

**February 2003**

---

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



**MINISTRY OF ENERGY AND UTILITIES**  
NEW SOUTH WALES GOVERNMENT

## Contents

---

<b>Contents .....</b>	<b>i</b>
<b>1 Introduction .....</b>	<b>1</b>
<b>2 Background .....</b>	<b>2</b>
<b>3 Rationale for ability to convert .....</b>	<b>3</b>
<b>4 ‘Optionality’ of Murraylink application .....</b>	<b>5</b>
4.1 Encourages gaming of the regulator .....	5
4.2 Negative commercial implications for other projects .....	6
<b>5 Regulatory cost of Murraylink .....</b>	<b>7</b>
5.1 Background .....	7
5.2 Murraylink approach to regulated cost base .....	7
5.3 Meaning of ‘alternative project’ .....	8
5.4 Flaws in Murraylink approach .....	9
5.5 Implications of Murraylink approach .....	12
5.6 Similar benefits approach preferable .....	13
5.7 Preferred approach – incremental benefits .....	14
5.8 Consequences of a higher regulatory cost base .....	17
<b>6 Conclusion .....</b>	<b>18</b>



## 1 Introduction

---

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

The Minister submits that the Murraylink application crystallises a number of unusual and contentious issues in the development of the NEM and must therefore be dealt with carefully to avoid imposing unnecessary charges on customers and setting a precedent that provides poor incentives for future investment in the market. This submission attempts to provide a framework for handling the application and is structured as follows:

- o section 2 provides the background to the application;
- o section 3 discusses the rationale for an MNSP's ability to convert to regulated status;
- o section 4 discusses the pitfalls of allowing regulated status to be an 'option' for Murraylink;
- o section 5 deals with the key question of the regulatory cost of Murraylink; and
- o section 6 provides the Minister's conclusions from this submission.



## 2 Background

---

The Murraylink application has been made in the following factual context:

- o the SNI project was initially proposed as Riverlink in 1998, before Murraylink became a committed project;
- o Murraylink has been operating as an MNSP since October 2002;
- o SNI has been granted regulated status by NEMMCO and this has been reaffirmed on appeal to the National Electricity Tribunal (NET) even treating Murraylink as ‘committed’;
- o the key reason for the NET’s decision was that Murraylink could impose ‘stranding risk’ on TransGrid, such that it was not practicable for TransGrid to develop ‘Unbundled SNI’<sup>2</sup>;
- o SNI is not at the commissioning stage; and
- o SNI’s estimated project costs are a fraction of Murraylink’s project costs.

The Minister submits that all but the last of these points is common knowledge held by participants in the National Electricity Market (NEM). Evidence on SNI costings is discussed in section 5.6 below.

---

<sup>1</sup> NEMMCO, Determination under clause 5.6.6 of the Code, SNI option (NEMMCO decision); NET, The Hon J Cripps, QC and Professor D Williamson, RFD, QC, Reasons for Decision, 24 October 2002 (NET decision).

<sup>2</sup> ‘Unbundled SNI’ was a term coined by Murraylink in the SNI appeal. It refers to those components of the SNI project not including the line from Buronga to Robertstown – see, for example, Statement of Anthony Steven Cook, paragraph 163. For the NET’s view on the practicability of ‘Unbundled SNI’, see NET decision, “Is USNI practicable?”, pages 48-56.

### 3 Rationale for ability to convert

---

Clause 2.5.2(c) of the National Electricity Code (Code) allows market network service providers (MNSPs) to apply, at the discretion of the regulator, to convert to prescribed (or regulated) status and earn a regulated return. It is worth examining the rationale for this provision.

As a rule, proponents of market-driven investments should not have the ability to convert to regulated status. The rationale for markets is to allow profit and loss incentives to guide efficient decision-making. If an investment proponent can effectively ‘fall-back’ on a regulated income, this dampens the incentives to make efficient investment decisions in the first instance.

Indeed, TransEnergie has consistently argued that, unlike regulated network investments, MNSPs are superior because they “*bear the full risks of their investment decisions*”.<sup>3</sup> In light of these and similar comments, it is somewhat hypocritical for Murraylink to seek to convert to regulated status.

More importantly, it is inconsistent for the Commission to have authorised the MNSP provisions on the basis that they provided net public benefits and then to find public benefits in the conversion of an MNSP to a regulated interconnector. NSW has argued on a number of occasions that the ACCC did not sufficiently justify its authorisation of the MNSP Code changes.<sup>4</sup> Whilst in its final determination on network pricing and MNSP, the Commission argued that MNSPs provided a source of competition for generators in importing regions,<sup>5</sup> NSW argued that MNSPs should be compared against regulated interconnectors, not against the absence of any project – that is not the correct counterfactual for authorisation purposes.<sup>6</sup> In its final determination on the Murraylink access undertaking, the ACCC explained its argument that MNSPs promoted inter-regional trade more fully:

“However, notwithstanding the market power issues that were identified in the draft decision, MNSPs can provide significant benefits to the NEM. For instance, in a similar way to generators, MNSPs are directly involved in the wholesale market and can offer opportunities for interregional hedges. The absence of interregional hedges reduces opportunities for market participants to manage the volatility of the spot market and therefore can be a barrier to interstate trade. The particular features of a DC link mean that the power is directly controllable, the power transfers are steady, and as a consequence, that the losses across the link are not large. This enables MTC to offer firm access to the link, and a firmer hedging instrument than the access provided by the AC networks provided by the existing TNSPs. As a result, there is less risk in interregional trading. In this regard, Murraylink’s ability to provide an

---

<sup>3</sup> See generally TransEnergie submission on ACCC Draft Decision on Network Pricing and MNSPs, pages 13-14.

<sup>4</sup> See, for example, MEU submission on ACCC Draft Decision on Murraylink Access Undertaking, August 2002, section 2.4.3, pages 10-11.

<sup>5</sup> Page 131.

<sup>6</sup> See Minister’s submission on ACCC Draft Decision on Murraylink Access Undertaking, August 2002, pages 9-10.



improved interregional hedging instrument is an important benefit in the context of adding competitors to regional markets.”

Given the Commission’s view on the public benefits of MNSPs, it is hard to see what public benefits might flow from the conversion of Murraylink to regulated status. After all, according to the above quote from the ACCC, this would mean the loss of a direct participant in the wholesale market who is capable of offering firm hedging instruments. Alternatively, to the extent that the Commission justified the MNSP provision on the basis that MNSPs would typically be DC links, it is submitted that the minor benefits of such links are significantly outweighed by the high costs of such links compared with AC links.

The Minister submits that it is difficult for the Commission to maintain that MNSPs have net public benefits – in order to justify their authorisation – whilst at the same time agreeing that there is a net market benefit from the conversion of an MNSP to regulated status. This seems to be a logically inconsistent position. To ensure a consistent approach, the ACCC should reject the conversion application on the basis that it is net detrimental to the market in light of the purported benefits of MNSPs the Commission has espoused in the past, or it could allow the conversion, but concede that its previous authorisation of the MNSP provisions may have been misconceived. If nothing is done to reconcile the Commission’s authorisation of the MNSP provisions with the present application for conversion, stakeholders might suspect that the Commission prefers market driven outcomes (eg MNSPs) to regulated solutions as a matter of philosophy, even where regulated solutions provide greater measurable net public benefits. The Minister believes that such an approach would raise policy issues of the highest order.

---

<sup>7</sup> Page 22 under “Market power issues”

## 4 ‘Optionality’ of Murraylink application

The Minister recognises that MNSPs have a right under the Code to apply to convert to prescribed or regulated status *if they have ceased to be classified as a market network service*.<sup>8</sup>

This implies that the Commission can only determine Murraylink’s application when it has ceased being classified as an MNSP. Taken literally, this means that Murraylink would have to cease or forgo operation as an MNSP and await the determination of the Commission as to its prescribed status application for its conversion to be valid. However, the Minister recognises that this outcome may not be in the interests of customers or the market as a whole. But at the very least, the wording of the Code would suggest that any application for regulated status ought to be irreversible, so that if regulated status is granted, Murraylink must submit to the regulation of the ACCC rather than have the right to choose to remain a MNSP. Murraylink should not have the option to simply explore regulatory options at its discretion.

To allow Murraylink to have the option to convert to regulated status at its discretion creates a number of serious policy problems. For example it:

- o encourages gaming of the regulator; and
- o has negative commercial implications for other proposed projects.

### 4.1 Encourages gaming of the regulator

In light of the NET decision on SNI (and subject to the Supreme Court appeal), the ACCC would be aware that it would be difficult to stop Full SNI being developed by TransGrid if Murraylink does not convert to regulated status. The ACCC has apparently made it clear that, in its view, if Murraylink converts to regulated status, ‘Interconnector SNI’<sup>9</sup> should not be built.” Presumably Murraylink is also aware of the Commission’s desire to avoid the development of Interconnector SNI. If Murraylink has the ability to withdraw an application for conversion after a regulatory cost base has been determined by the Commission, then the Commission may be influenced in the setting of Murraylink’s regulatory cost base. The Commission would be aware that if it set a regulatory cost base that was unattractive to Murraylink, Murraylink could withdraw the application and remain an MNSP for a time before perhaps applying to convert again. Murraylink would know that the result of this could be the development of Full SNI, an outcome the Commission seems keen to avoid. The result is a bargaining game where both parties hold some bargaining power. The likely result of this game is an outcome where Murraylink achieves a better regulatory cost base than it would achieve if it had no bargaining power (ie no option to withdraw its application). In contrast, TNSPs do not face this ‘optionality’ at their revenue determinations and so the ACCC is not placed in a position of

<sup>8</sup> Clause 2.5.2(c) of the Code.

<sup>9</sup>The term ‘Interconnector SNI’ was used in the SNI appeal to refer to the Buronga to Robertstown line. ‘Full SNI’ is ‘Unbundled SNI’ (refer note 2) plus ‘Interconnector SNI’.

<sup>10</sup> The Minister understands that the Commission has written to TransGrid to discourage the development of Interconnector SNI.

having to potentially give ground to TNSPs in order to avoid inefficient or undesirable outcomes. To avoid this problem, once an application for conversion is made, it must not be able to be withdrawn.

## 4.2 Negative commercial implications for other projects

Murraylink's application has important implications for other projects in the market. The SNI project has been granted regulated status after time-consuming and extensive analysis and review and has recently won a NET appeal against that decision initiated by Murraylink. Now Murraylink has lodged a further appeal with the Supreme Court of Victoria. At the same time, Murraylink has applied for regulated status. This latest application may deter or delay SNI, a project that NEMMCO and the NET have agreed deserves regulated status. It would not be in the interests of a rational transmission planning and development regime for Murraylink to effectively use the regulated status application as yet another strategy in the fight against SNI.<sup>11</sup> Allowing Murraylink the ability to 'take or leave' the regulatory treatment (and revenues) the Commission determines effectively allows Murraylink to treat the application as a low-cost 'option' to further delay or deter SNI.

The Minister submits that a regulatory framework that allowed such gaming to occur would be highly unsatisfactory for the integrity of the NEM and the welfare of customers and the market as a whole. Proponents of transmission augmentations should not have the ability to undermine or disrupt the development of rival regulated or non-regulated projects through exercise of a low-cost option to convert to regulated status.

---

<sup>11</sup> Regarding the use of this language, in the SNI appeal, Murraylink's "Written submissions on behalf of the applicant" stated, at paragraph 20, page 9:

"it was not in serious contention that if the SNI interconnector is built, the Murraylink interconnector will be at real risk of failing ie. the investment will not be utilized and/or recouped.

See also paragraph 59(iii), page 22:

"if the SNI option is justified at this time, the Murraylink interconnector will be at real risk of failing commercially;"

## 5 Regulatory cost of Murraylink

---

### 5.1 Background

The key issue that the Commission needs to consider in the voluminous application is the regulatory valuation of Murraylink. In order for the conversion of Murraylink to be in the interests of the market – and in particular customers who must pay transmission charges – the regulatory valuation of Murraylink must be at a reasonable level to ensure the remainder of the market does not suffer relative to the counterfactual situation of no regulated status being granted.

The Minister agrees with Murraylink that the ACCC's Regulatory Test sets out the core of the framework for consideration of Murraylink's regulated cost base.<sup>12</sup> The Regulatory Test requires that an augmentation satisfies the test if it:

“maximises the net present value of the market benefit having regard to a number of alternative projects, timings and market development scenarios.”<sup>13</sup>

More generally, the use of optimised deprival value (ODV) should lead to a regulated cost base consistent with what would flow from the Regulatory Test. To this extent, ODV can be applied Murraylink. However, as the Commission's Final Determination on Network Pricing and MNSPs stated, the use of ODV should not provide a material advantage to NSPs converting from market to prescribed status through bypass of the regulatory test.<sup>14</sup>

### 5.2 Murraylink approach to regulated cost base

The Murraylink application argues that the regulatory cost of Murraylink should be the lesser of:<sup>15</sup>

- o the full life-cycle cost of the lowest cost alternative project;
- o the estimated life-cycle cost of Murraylink itself; and
- o the value of the gross market benefits Murraylink provides.

Murraylink finds that because the costs of 'alternatives' to Murraylink are greater than the gross market benefits of Murraylink, the third of these caps applies.

---

<sup>12</sup> Murraylink application, section 1.3.4, page 4 and section 4 generally.

<sup>13</sup> Page 21.

<sup>14</sup> ACCC, *Applications for Authorisation, Amendments to the National Electricity Code, Network pricing and market network service providers*, 21 September 2001 (Final Determination on Network Pricing and MNSPs), section 10.2.5, under “Commission's considerations”, “Conversion process”, page 138.

<sup>15</sup> Murraylink application, section 4.4.5, page 29.

Whilst Murraylink's approach to valuation is an attempt to be consistent with an ODV approach, the application of the approach to Murraylink itself is seriously flawed and ignores the fact that Murraylink is already operating as an MNSP in the NEM. These issues will be discussed in the following sub-sections.

### 5.3 Meaning of 'alternative project'

The first possible cap on Murraylink's regulatory cost is the life-cycle cost of 'alternative projects'. However, Murraylink's application sought to characterise the meaning of 'alternative' project under the Regulatory Test as a project "providing the same technical service and gross market benefits as Murraylink".<sup>16</sup> This approach was repeated throughout Burns and Roe Worley's report (BRW), included in the application", in particular section 3.2.1, page 5, which states:

"Implicit in the determination of an alternative project is the requirement that it achieve the same technical service offered by Murraylink."

The technical service offered by Murraylink is alleged to include (in brief):

- o between 110 and 220 MW of transfer capability into the South Australian region;
- o power transfer capability from Victoria to South Australia even when the Heywood interconnector is constrained;
- o an additional 220 MW injection capability into Victoria from South Australia subject to constraints in the Riverland area;
- o reactive support in a controlled manner; and
- o an additional transmission in-feed into the Monash substation."

On this basis, the application:

- o rejects generation in South Australia and the Riverland, as well as demand-side management, as alternative projects to Murraylink – on the basis that although:

"They represented possible options for meeting Riverland load requirements... in all other respects they were not equivalent to Murraylink."<sup>19</sup>; and

- o requires the transmission alternatives to Murraylink to provide the same services as Murraylink – the remaining options considered by Murraylink are one DC and three AC links either between Buronga, Red Cliffs or Robertstown to Monash. BRW state in their report that:

---

<sup>16</sup> Murraylink application, section 4.8, page 32.

<sup>17</sup> See Murraylink application, Appendix F: "Report – Selection and Assessment of Alternative Projects – Burns and Roe Worley Pty Ltd, Executive Summary, page II; section 1, page 1; section 2, pages 2-3 (hereinafter referred to as Appendix F).

<sup>18</sup> Murraylink application, Appendix F, section 3.1.2, pages 4-5.

<sup>19</sup> Murraylink application, section 4.8, page 32. See also Appendix F, section 4.1, page 12.

“In developing the alternatives, each project was designed to provide the same services as Murraylink. This required AC transmission alternatives to include both phase shifting transformers (‘PST’) and static var compensators (‘SVC’).”<sup>20</sup>

Needless to say, the cost of equipment such as phase shifting transformers and static var compensators is substantial and adds significantly to the cost of the mooted alternatives to Murraylink.<sup>21</sup> The Saha Report also states that Murraylink did not provide sufficient justification for undergrounding 30km of cable.“

This approach allows Murraylink to build up an alternative project cost of over \$240 million<sup>23</sup>, well above the proposed costs of (even Full) SNI (see section 5.6 below). The Minister challenges Murraylink’s application and submits that a more appropriate benchmark for costing alternatives to Murraylink is the costs of a project that delivers similar benefits, such as SNI, for the reasons set out below. This would lead to a substantial reduction in Murraylink’s regulatory cost base compared with what has been proposed.

## 5.4 Flaws in Murraylink approach

The Minister’s disagreement with Murraylink’s approach to the definition of ‘alternative projects’ is based on the:

- o Regulatory Test;
- o Draft Statement of Regulatory Principles; and
- o ACCC Final Determination on MNSPs.

### Regulatory Test

The Commission’s commentary on the Regulatory Test states:

“In order to assess whether a network augmentation or interconnector proposal generates a net public benefit that is greater than other alternatives, the range of costs and benefits associated with each alternative and their likely impact on future market outcomes need to be estimated and included in the analysis. For example, it might be predicted that a network constraint might arise at some time in the near future given the forecasts of load growth. This constraint could be resolved in a number of ways:

- i. First, the network could be augmented to increase the import capability from remote generation.

---

<sup>20</sup> Murraylink application, Appendix F, page 11; see also pages 5-6, including Table 3.2.1.a.

<sup>21</sup> See Saha Energy International Ltd, “Review of Murraylink Transmission Company Pty Ltd’s Application of the Regulatory Test”, Final Report, February 2003 (Saha Report), Table 3.1, page 54 (approx cost of these additions is \$38 million).

<sup>22</sup> Section 5.2, pages 80-81.

<sup>23</sup> Murraylink application, Appendix F, Table 4.7.2.a, page 22.

- ii. Second, the supply of electricity could be augmented through the construction of a local generator that operates close to load and on the inside of the network constraint.
- iii. Third, demand side projects could be implemented to reduce load. This could consist of options that attempt to reduce energy consumption overall such as investments in more energy efficient equipment and appliances. Alternatively, options could include arrangements aimed at reducing the growth in demand during peak periods, either by shifting demand from peak to shoulder or off-peak periods (eg peak load pricing) or through voluntary load shedding arrangements where customers agree to have their supply interrupted/curtailed on specified terms and conditions.

Each of these options is likely to generate their own stream of benefits and costs. For instance, the local generation option may avoid or defer the need for a network augmentation, it may displace electricity otherwise generated by a remote generator (ie operating and fuel cost savings) and it may delay the need for new generation at some future time.”<sup>24</sup>

This commentary suggests that the Commission did not wish to overly circumscribe the nature of alternative projects under the Regulatory Test. The Commission recognised that a variety of projects could provide similar but not identical benefits and costs to the project in question and that the issue was maximising the present value of the *net* market benefit, rather than obtaining the same technical service or level of **gross** market benefits.

To use the Regulatory Test to discard a generation or DSM alternative, as Murraylink has done, completely flies in the face of the intent of the Regulatory Test, which is designed to avoid awarding regulated status to an augmentation where a generation, DSM or MNSP option offers greater net benefits. Similarly, to use the Regulatory Test to avoid comparing network alternatives (such as SNI) that provide similar benefits is also inappropriate.

### **Draft Statement of Regulatory Principles**

In justification of its approach to limit alternatives to those that provide equivalent services, Murraylink’s application also refers to the ACCC’s Draft SORP:

“Its is important to note that the Draft Regulatory Principles do not restrict the definition of ‘service delivery’ to that only associated with basic technical service, particularly just those associated with reliability requirements. The Draft Regulatory Principles encourage the services provided by the network asset to be considered in the broadest possible perspective.”<sup>25</sup>

---

<sup>24</sup> Section 3.2, under “Issues for the Commission”, pages 7-8.

<sup>25</sup> Murraylink application, page 27.

This passage gives the impression that an alternative project needs to provide the same or almost identical level of service to that provided by the project being assessed, even if such level of service is well above what is required by the Code or other legal instruments. The ACCC Issues Paper states that:

“In previous applications of the market benefits limb of the regulatory test the alternative projects considered provided similar but not equivalent levels of service. However, the Commission notes that MTC’s selection of alternative projects is consistent with an Optimised Depreciated Replacement Cost (ODRC) valuation process.”<sup>26</sup>

The Minister disagrees. The Murraylink passage above refers to page 43 of the Draft SORP. The relevant paragraph of the Draft SORP dealing with optimisation risk – a risk that Murraylink sought to downplay in the SNI appeal – reads:

“Generally, a top-down approach, which considers infrastructure from a system-wide perspective is important since it allows major differences from existing infrastructure to be quickly identified. Moreover, the top-down approach can more readily accommodate the impact of new or alternative technologies. For example, an optimal solution may do away with existing types of infrastructure and may involve a totally different transport mechanism or product to satisfy associated final demand in end markets. Such solutions may only be apparent when the customer base and services provided are considered in the broadest possible perspective.”

It is clear from the relevant paragraph of the Draft SORP that the Commission’s intention was to ensure that *all possible alternatives* to satisfy demand should be considered as part of an asset revaluation process, not that all possible replacements for a particular component of network must provide the same level of technical service as the component under review. Murraylink’s application attempts to distort this section of the Draft SORP to support its flawed approach.

The Draft SORP notes that any regulatory value that is in excess of DORC is likely to imply pricing of services that will expose the service provider to being by-passed.” In a competitive market, the use of a technologically circumscribed approach to alternative projects, as proposed by Murraylink, would indeed lead to the risk of by-pass by options, such as SNI, that are capable of providing similar services for much lower cost (see section 5.6 below regarding SNI costs).

Restating the approach of the Draft SORP to the present application, the valuation of Murraylink should not be referenced to the technical characteristics of the project itself, but to DSM, generation or network alternatives that could feasibly address the same approximate load.

If a project provides additional or special benefits – such as reactive support – as Murraylink argues that its project does, these may be

---

<sup>26</sup> Page 4.

<sup>27</sup> Page 40.



included in the calculation of gross benefits under the Regulatory Test to the extent that the Test allows. Specifically, such benefits may be included in the assessment if they can be measured as a benefit or cost to producers, distributors and consumers of electricity in terms of financial transactions in the market. Any other benefits are to be disregarded.”

### **ACCC Final Determination on MNSPs**

The Commission’s Final Determination on Network Pricing and MNSPs supports the Minister’s view that the scope of alternatives should not be restricted to those that provide the equivalent technical service. As quoted in the Issues Paper, the Commission stated in its Final Determination on MNSPs:

“The Commission considers that the DORC valuation allows for consideration of all possible options for replacing existing network services, as well as consideration of current and future utilisation rates. The effect of a DORC valuation will be that the network is valued to reflect the least cost solution to resolve any demand and supply imbalance needing to be addressed. Thus the process of changing status of network services requires the NSP to submit to a valuation process that delivers outcomes consistent with the intent of the regulatory test. The processes set out in the Draft Regulatory Principles may be simpler than the regulatory test processes but the Commission considers that no material advantage will accrue to NSPs converting from market to prescribed status through bypass of the regulatory test. [emphasis added]”<sup>29</sup>

This passage puts heavy emphasis on least-cost solutions rather than the provision of regulatory returns in respect of elaborate and arguably unnecessary network services. It also confirms that the conversion process should not materially advantage an MNSP compared with the Regulatory Test process. If the Regulatory Test were applied to Murraylink *ex ante*, then it is difficult to see how a project that offered similar benefits but not the same services could be excluded from the choice of alternative projects. Therefore, there are no grounds for allowing Murraylink a regulatory cost that involves the omission of comparison with alternative projects that provide similar benefits to Murraylink.

## **5.5 Implications of Murraylink approach**

From the above discussion, it appears that what Murraylink is attempting to do is to assess Murraylink under the cost effectiveness (or ‘reliability’) limb of the Regulatory Test. In this context, the Commission stated the following in its commentary on the Test:

“The cost effectiveness criterion will be equivalent to the market benefits criterion where the various options provide a very similar level

---

<sup>28</sup> Regulatory Test, note 4, page 23.

<sup>29</sup> Page 138.

of benefits (ie the service standard requirement) so the assessment of benefits is no longer an important distinguishing element of the test.”<sup>30</sup>

The Commission goes on to set out the two limbs of the Regulatory Test, one that deals with maximising net market benefits and one that deals with cost minimisation for projects linked to satisfying the reliability standards in Schedule 5.1 of the Code. The Commission recognised that certain projects might not yield net benefits even though they are necessary to satisfy prescribed service standards.

In effect, Murraylink is applying a cost minimisation test to its investment, which is market-driven and not designed to satisfy a clearly defined service standard in schedule 5.1 of the Code. This approach is precisely what the Commission intended to avoid when it developed the ‘reliability limb’ of the Regulatory Test. The reason why the Commission limited the application of the reliability limb to prescribed service standards in schedule 5.1 of the Code was to prevent proponents from building elaborate projects and then applying a cost-effectiveness test to these projects.

By contrast, Murraylink’s approach to the selection of alternative projects is geared towards gold-plating. Acceptance of Murraylink’s approach would lead to network service providers building elaborate projects (albeit with a net benefit) and then apply the Regulatory Test by only comparing their project to other, similarly elaborate projects and selecting the option that provides the elaborate services at the lowest (but still substantial) cost. This is likely to lead to much higher costs for customers than has been the case to date in the NEM and therefore should be rejected by the ACCC.

## 5.6 Similar benefits approach preferable

In light of the discussion above, the Minister submits that the DORC-based regulatory cost cap on Murraylink should not reflect the cost of projects that provide the same or equivalent service as Murraylink, but rather, should reflect the cost of projects that provide similar benefits. Specifically, Murraylink’s regulated cost should be capped by the costs of the ‘interconnector’ portion of the SNI project – that is, the line and works associated with the proposed 275 kV AC link between Buronga and Robertstown. On this matter the ACCC ought to head the advice of Murraylink itself:

“Functionally, there is little difference between Murraylink and the Buronga to Robertstown component of SNI”<sup>31</sup>

---

<sup>30</sup> Page 10.

<sup>31</sup> SNI appeal, Statement of Anthony Steven Cook, paragraph 117. See also paragraph 116, which states:

“Figure 2.1 illustrates that the component of SNI consisting of a transmission line from Buronga to Robertstown duplicates Murraylink, which runs between Red Cliffs and Berri. This is despite the fact that the eastern terminal of Murraylink is located in Victoria while the proposed eastern terminal of SNI would be located in NSW.”

The Minister is not in a position to provide technical submissions in respect of interconnector construction costs. However, the Minister understands that the proposed costs of SNI project, including all the required upstream augmentations are in the vicinity of \$111 million and much less if only the ‘interconnector’ components of SNI are considered.<sup>32</sup> The latter lower figure should be used to guide the *maximum* allowable regulated cost base for Murraylink on the basis of a DORC approach. It would be likely to be less than half the value that Murraylink is proposing. The Minister contends that the Commission should request and consider data from TransGrid in relation to SNI cost figures, if these data have not already been provided as part of TransGrid’s submission on the present application.

## 5.7 Preferred approach – incremental benefits

The ACCC’s Issues Paper invites comments on the appropriateness of Murraylink’s application in light of the fact that Murraylink has been operating as an MNSP since October 2002.<sup>33</sup> This brings two issues to the fore:

- o That Murraylink is a sunk asset; and
- o That the Regulatory Test would suggest a regulatory cost based on the incremental value of Murraylink’s conversion.

### Sunk asset

The ACCC’s Draft SORP said the following about sunk assets:

“In determining an appropriate asset valuation methodology economic principles and analysis do not provide an unambiguous decision rule for the valuation of existing sunk assets. Rather economic principles provide lower and upper bounds – scrap value and replacement cost. Within these bounds there is opportunity for regulatory judgment.”<sup>34</sup>

Clearly if an asset is sunk, an efficient value for that asset can be anywhere between scrap value – the best alternative use of the asset to its owner – and the replacement cost of the least cost option that provides similar benefits – which corresponds to the opportunity cost to the market of being deprived of the asset. The Commission states that between these bounds there is scope for regulatory judgement. Another way of interpreting this statement is that: *an efficient regulatory cost base can be anything that does not make a party worse off than the party could otherwise be from a bargaining outcome.*

In the case of assets that have no real alternative use but to be regulated – such as the sunk networks of incumbent TNSPs – the use of an ODV approach (as suggested in the Draft SORP) would imply a regulatory cost base of the lesser of economic value and DORC. In this context, ODV is a price consistent with a possible bargaining solution between TNSPs and the remainder of the market.

---

<sup>32</sup> SNI appeal, Statement of Colin James Parker, paragraphs 64 to 76, pages 20 to 24.

<sup>33</sup> Page 5.

<sup>34</sup> Page 39.

However, where the asset under consideration is already available to the market as an MNSP, the Minister suggests that the ODV approach needs to be modified to comply with the above principle. This is consistent with the use of the Regulatory Test.

### **Incremental benefits of conversion**

The Regulatory Test assesses proposed investments on the basis of their incremental costs and benefits. In the present case, the Regulatory Test is being used to assess not the development of a new asset, but the conversion of an existing asset to regulated status.

Murraylink is already in operation as an MNSP and likely to remain in operation even if it does not or cannot convert to regulated status. It is likely that even if Murraylink's prescribed status application were rejected, it would continue to operate as a MNSP so long as its scrap value was low and it could cover its variable costs of operation – basically, losses and operations and maintenance costs. Both of these preconditions are highly likely to be fulfilled.

Therefore, it could be said that the market (other than Murraylink) obtains certain benefits from Murraylink's existence as an MNSP and pays certain costs – the revenues of Murraylink.<sup>35</sup> This is the starting point of the analysis.

The opportunity cost to Murraylink's owners of Murraylink converting to regulated status is the expected value of Murraylink's profit stream as an MNSP. Murraylink would not voluntarily agree to an outcome under which it received less than its expected profits as an MNSP. Meanwhile, the net benefit to the market of Murraylink as an MNSP is the gross market benefit of Murraylink as an MNSP less what the market has to pay for Murraylink as an MNSP (ie the revenue stream Murraylink would earn as an MNSP). This is the minimum net benefit the market will receive from Murraylink, whether or not it converts to regulated status. The market would not (and the ACCC should not on its behalf) accept a lower stream of net benefits than this in any conversion process.

The issue the Commission then has to consider is: "What is the incremental benefit of Murraylink's conversion to regulated status and how should that benefit be allocated?"

The incremental benefit of Murraylink's conversion arises from its inability (once regulated) to bid above zero (ignoring losses). Assuming Murraylink's average level of dispatch would increase following conversion, there would be an increase in the sum of consumer and producer surplus in the NEM from the conversion. At the same time, the incremental costs of the increased dispatch are likely to be minimal.

---

<sup>35</sup> The expression 'the market' in this sub-section (only) will refer to the surpluses earned by persons other than Murraylink. In the normal application of the Regulatory Test, the surpluses earned by the proponent NSP are not included in the definition of 'market benefit' – see Note 4 of the Regulatory Test.

The determination of the incremental benefits of Murraylink's conversion requires market modelling. Whilst this submission does not provide such modelling results and recognises that this will not be straightforward, documents prepared for the SNI appeal provide a useful starting point. In the SNI appeal, TransGrid tabled a report from its consultants, Intelligent Energy Systems (IES) that alleged that Murraylink average flow from Victoria to South Australia would fall from 140 MW (if it bid at a zero price differential – equivalent to a regulated interconnect) to 118 MW (if it were an uncontracted MNSP). Dr Cook from Murraylink appeared to accept these figures as a pessimistic maximum limit to Murraylink's incentive to restrict its flows.<sup>36</sup> In fact, Dr Cook argued that, in his view, Murraylink would only experience 617 hours in 2002 when it was profitable to restrict flows.<sup>37</sup> This is much less than modelled by IES. Dr Cook stated:

“This analysis would suggest that the IES study (which finds that MTC could profitably withhold capacity for 3,965 hours/year) greatly exaggerates the potential for MTC to profitably restrict flows across Murraylink.”<sup>38</sup>

In fact, Dr Cook himself conducted some analysis and argued that Murraylink may be dispatched more often as a MNSP than it would if it were a regulated interconnect by bidding at a negative price differential:

“I conclude from this analysis that Murraylink could be dispatched more often than a regulated interconnector. If there were a risk of stranding to those assets which comprise Unbundled SNI, Murraylink could actually reduce that risk as compared with the impact on those assets of full SNI. The above analysis [see paragraphs 124-125] also shows that there is a much greater risk of the assets which comprise the Buronga – Robertstown component of SNI (should that be built) being stranded, that is, there is often an incentive for Murraylink to ensure its flow by dispatching below its (and the proposed Buronga-Robertstown interconnector's) marginal cost.”<sup>39</sup>

All this suggests that the Commission should assess the incremental benefit to the market of granting Murraylink regulated status on the basis of an additional supply to South Australia of *no more than 22 MW* (on average). Without granting regulated status, Murraylink should operate at an average flow of approximately 118 MW and with regulated status, it should operate at an average flow of approximately 140 MW – remembering that Dr Cook of Murraylink stated that these figures *exaggerated* the incentives for Murraylink, as an MNSP, to restrict flows. Calculating the market benefit arising from an extra 22 MW of capacity should not be an overly difficult exercise.

On this basis, in order to make both Murraylink and the market better off from the conversion, the Commission should set a regulatory asset cost for Murraylink somewhere between:

---

<sup>36</sup> Statement of Anthony Steven Cook, paragraphs 118-120.

<sup>37</sup> Statement of Anthony Steven Cook, paragraph 122.

<sup>38</sup> Statement of Anthony Steven Cook, paragraph 123.

<sup>39</sup> Statement of Anthony Steven Cook in Reply, paragraph 126. See also paragraphs 124-125 for the analysis he refers to.

- Murraylink's foregone profits as an MNSP; and
- Murraylink's foregone profits as an MNSP plus the expected market benefit from an average additional 22MW capacity in South Australia.

Any regulatory asset cost within these bounds would be consistent with a possible bargaining solution between Murraylink (as an existing MNSP) and the market (as represented by the ACCC). One possible approach to determining a precise figure within these bounds is to value the additional 22 MW on an ODV basis – the lesser of economic value and DORC. Assuming that economic value for an incremental 22 MW of capacity in South Australia is less than the DORC of 22MW of Murraylink, this would put the regulatory cost towards the higher bound (the second bullet point).

As an aside, it should be noted that Murraylink's foregone profits as an MNSP should be calculated on the basis of market development scenarios that have Full SNI as at least an 'anticipated project'. SNI was found to be justified by both NEMMCO and the NET even with Murraylink treated as a committed project. Therefore, it is reasonable to expect that if Murraylink remained an MNSP, Full SNI would be developed. Therefore, Murraylink's commercial prospects as an MNSP would need to be determined in the context of Full SNI being developed in accordance with current timeframes.

## 5.8 Consequences of a higher regulatory cost base

To allow Murraylink a regulatory cost base greater than the higher bound suggested above would have the effect of making the market (apart from Murraylink) worse off than if either it could bargain with Murraylink itself over the conversion application or indeed if Murraylink remained an MNSP.

Whilst from a whole-of-market perspective (including Murraylink) it may be possible to set a higher regulated cost base than suggested here – up to the level of Murraylink's gross economic benefits – and achieve net benefits overall, the position of the market apart from Murraylink would be unambiguously worse.

In light of the Code requirements<sup>40</sup> that the transmission regulatory regime ought to:

- o prevent monopoly rent extraction by networks; and
- o reach an acceptable balance between the interests of network providers and network users and the public interest,

it is submitted that a regulatory cost base that made the market (apart from Murraylink) worse off than if Murraylink remained an MNSP would be extremely inappropriate.

---

<sup>40</sup> Clause 6.2.2 (c) and (k)

## 6 Conclusion

---

The Minister believes that Murraylink's approach for regulated status highlights important deficiencies in the MNSP regime, particularly the basis on which the MNSP Code provisions were justified.

Nevertheless, the Minister accepts that Murraylink converting to regulated status might avoid inefficient duplication in the present case. However, the Minister submits that the Commission should adopt an approach towards the application that does not penalise the remainder of the market relative to the counterfactual of no regulated status being granted.

In this regard, the Minister submits that:

- the process of conversion should not allow Murraylink to effectively hold an option to convert to regulated status depending on the outcome of the Commission's determination on the regulated cost base. This could lead to gaming of the regulator and negative impacts on other stakeholders;
- the regulated cost base of Murraylink should be guided by the intent of the Regulatory Test, which is to compare the incremental benefits and costs of the relevant regulatory decision. In other words, the incremental costs and benefits of the conversion of Murraylink to regulated status, keeping in mind that the counterfactual to conversion is likely to be Murraylink remaining an MNSP;
- consequently, the *maximum* regulated cost base of Murraylink should be the expected net profits of Murraylink as an MNSP (given that Full SNI would likely go ahead under this scenario) plus the ODV of approximately 22 MW capacity in South Australia;
- if the incremental benefit approach is not acceptable to the Commission, the regulated cost should be no more than the costs of genuine alternatives to Murraylink (such as SNI), rather than by extravagant projects that will increase regulated augmentation costs in the NEM now and into the future. The Minister believes that adoption of Murraylink's flawed approach to selecting 'alternative projects' would lead to customers paying more than double the charges that would apply if a more appropriate cost basis were used; and
- it should be noted that if the incremental benefits approach is rejected, and a higher cost base provided to Murraylink, the remainder of the market would be made worse off than if Murraylink remained an MNSP. Such an outcome could not be consistent with the intent of the Code.