Origin energy

27 May 2002

Mr Michael Rawstron
General Manager
Regulatory Affairs-Electricity
Australian Competition and Consumer Commission
PO BOX 1199
Electricity.group@accc.gov.au

ACCC Regulation of the South Australian Transmission Network: Transmission Revenues

Dear Mr Rawstron,

Origin Energy welcomes the opportunity to provide a submission to the Australian Competition and Consumer Commission's (ACCC) review of the Electranet revenue cap application.

Origin wishes to comment on a number of issues in respect of the application.

First, because any increases in the revenue cap will affect retailer margins, Origin believes retailers' regulated tariff and revenue cap reviews ought to be considered together, and not by separate regulators at different times.

Second, we believe it is crucial that any increases in revenue are directly related to rigorously applied 'efficient' cost criteria taking account of international benchmarks and, third, that the behaviour of transmission network service providers (TNSPs) is consistent with the broader operation of the market.

These last two points require, in Origin's view, the establishment of an appropriate incentive structure for TNSPs in the short term, as well as, in the longer term, the creation of a 'national transmission planner'.

These issues are briefly discussed below.

Pass through of costs

The ultimate beneficiaries of new 'efficient' network investment are end use customers, who benefit through lower prices (due to enhanced competition between generators on the network) and the increased reliability of the network.

In this context, Origin is of the view that any increases in its regulated network tariffs should therefore be able to be passed through to its regulated customer base.

While we recognise this is probably an issue for state government regulators in respect of their retail tariff reviews, it is unfortunate that retail tariff and revenue cap reviews are considered independently and by different regulators.

These reviews need to be closely coordinated as inconsistent regulatory decisions may impose additional costs on retailers that they are unable to pass through to their customers (the beneficiaries).

Efficient Costs

Electranet is asking for a substantial increase its maximum allowable revenue (MAR). While Origin concurs that appropriate investment in the network is important, we are strongly of the view that expansion represents the 'least cost' solution to addressing network issues such as congestion and line losses. Network augmentation should not take place at the expense of potentially cheaper alternatives such embedded generation, demand side management or entrepreneurial links.

Therefore any call by Electranet for increases in its revenue cap ought to be rigorously evaluated. In this context Origin has a number of concerns with Electranet's assessment of its weighted average cost of capital (WACC). In particular we note that:

- Electranet's claim for a risk-free rate of return based on 10-year government bond rate is inconsistent with the ACCC's *draft regulatory principles* and previous revenue cap decisions.

- Electranet's proposed equity Beta of 1.12 implies that it is exposed to greater than average market risk. This is unlikely given that it operates in a regulated environment with stable cash flows. To provide an international comparison we observe that OFGEM has only allowed an equity beta of 1 for the National Grid Company (NGC) in the UK[1].

- Electranet argues that its market risk premium (MRP) should be 7 rather than the current figure of 6. We agree, however, with the ACCC that recent trends in financial markets and inflation indicate the premium should be lower. We draw attention again to OFGEM, which calculated a MRP of 3.5 for the NGC.

- Electranet's claim for an asset Beta of 0.45 is based, in part, on comparison with AGL. This is inappropriate give that AGL also runs a retail business with additional risk. Indeed, Electranet provides no clear rationale as to why AGL and United Energy were chosen as its comparators. OFGEM allocated an asset beta of 0.4 to NGC.

Electranet's rationale for an increase in its WACC would require a significant change in approach by the ACCC and would therefore be inconsistent with previous revenue cap decisions. This would increase the level of regulatory risk in the market.

It is also not clear to us that Electranet's requirements would reflect world's best practice. We note that Electranet requires a WACC (pre-tax, 8.46) significantly in excess of that of the UK's principle network owner, NGC (pre-tax, 6.25), widely considered to be one of the world's most efficient and successful network owners and operators.

However, we recognise that this is only one comparison and does not account for potential international differences. We therefore call for the ACCC to further investigate the performance of Australian transmission companies in an international context and ensure that best practice principles apply.

Performance incentives

Nevertheless, Origin recognises the inherent difficulties external parties face in determining the 'efficient' costs of regulated entities. In our view,

[1] Ofgem ' The transmission price control review of the National Grid Company from 2001: final proposals

it is therefore critical that regulation encompasses an appropriate incentive framework, encouraging TNSPs to strive for efficient costs without necessarily relying on heavy-handed regulation.

While to some extent the CPI-X revenue cap formula provides this, the key weakness of this framework is that it incentivises TNSPs to minimise their own costs while taking no account of the energy market more generally.

Origin therefore strongly supports the current reviews by NECA and the ACCC to find ways in which TNSP behaviour can take greater account of such externalities.

Key to this process will be a reassessment of the form and level of the regulatory cap, with the potential to allow for adjustments (to the X component for instance) that are closely linked to appropriate performance measures.

It is also important that as soon as these measures are developed there is scope for them to be incorporated into the regulatory cap, before the next reset if necessary.

TNSP restructuring

Origin considers that in the longer term a further key reform to improving TNSP incentives is the separation of ownership and investment planning functions and coordinating planning at a national level

The current existence of these functions in a single entity results in a clear tension between excessive expansion of the network, in order to increase the applicable regulatory cap (gold-plating), and too little expansion in fear of re-optimisation. Given this tension it is unlikely that the actual level of investment in the network will be efficient.

A further key problem is that by owning the network TNSPs have little incentive to consider any alternatives in addressing network issues. Consequently, less costly solutions to minimising transmission costs in the NEM, such as demand management and embedded generation, may not be adequately considered in the investment process, leading to excessive expansion of the network.

In addition, the regional location of TNSPs results in a regional focus in transmission investment, with intra-regional and inter-regional network augmentations not always proceeding on the basis of market wide benefits.

In respect of these issues, Origin has previously indicated its support for the concept of a 'national transmission planner'. Origin believes this would eliminate incentives to over build the network and to overemphasise regulated network options at the expense of alternatives, providing greater confidence that any applicable revenue cap would reflect the efficient operation and expansion of the network.

Conclusion

Origin has outlined some of its concerns with Electranet's application for an increase in its revenue cap. However, ultimately Origin considers that the best way to deal with the difficulties inherent in determining the 'efficient' level of costs for a monopoly provider is by creating an appropriate incentive framework.

To this end we support aligning TNSP behaviour with its wider market impacts. However, in the longer term Origin believes that such a regime would be significantly enhanced with the creation of an independent national transmission planner, which would, in our view, substantially increase the accountability, transparency, and integration of network investment in the NEM.

If you wish to discuss any of these issues further please do not hesitate to contact Mark Landis on (03) 9652 5569

Yours Sincerely,

(sgd) Mark R. Landis for

Tony Wood
General Manager Public & Government Affairs