22 October 2004

Mr Sebastian Roberts
General Manager
Regulatory Affairs-Electricity
Australian Competition and Consumer Commission
GPO BOX 520J
Melbourne VIC 3001

By e-mail electricity.group@accc.gov .au

Dear Mr Roberts

STATEMENT OF PRINCIPLES FOR THE REGULATION OF ELECTRICITY TRANSMISSION REVENUES-DRAFT DECISION

Origin appreciates this opportunity to provide some further comments to the Australian Competition and Consumer Commission (ACCC) review of *Statement of Principles for the Regulation of Electricity Transmission Revenues.*

Asset Base

In our submission of the 21 November 2003, Origin indicated its preference for using a depreciated optimised replacement cost (DORC) revaluation methodology for valuing the asset base, with redundant assets optimised out of the regulatory asset base (RAB) at the end of the revenue cap period. We felt this most closely resembled the kind of incentives that might be operating on transmission companies in a competitive environment.

In its draft determination the ACCC outlined extensively it concerns with this approach, in particular the uncertainty and subjectivity surrounding estimation of efficient replacement costs and applying ex post optimisation in a defensible manner. The unavoidable uncertainty surrounding this approach discourages incentives to invest in the network, and appears to have made the ACCC somewhat reluctant to revalue assets in this manner, arguably further undermining the credibility and incentive properties of this approach.

The ACCC proposes to replace the ex post optimisation framework with and ex ante approach, which establishes a pre-agreed expenditure cap for the regulatory period going forward. Expenditures falling within the cap over this time are considered prudent and will be included in the regulatory asset base at the next reset. Transmission companies will retain any cost savings arising from expenditures falling below the cap provided they do not breach service quality and reliability guidelines. The costs of any expenditure above the cap, however, with the exceptions outlined below, will be borne by the transmission companies themselves.

Origin is persuaded that this approach strikes a good balance between improving certainty and predictability for transmission companies, while at the same time providing appropriate incentives for disciplining the costs of network investment over time.

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Exclusions from the expenditure cap

Another key element of the ACCC's proposed approach is to provide the opportunity for large but uncertain investments to be excluded from the revenue cap. Such investments would then be incorporated into the asset base at a later stage, provided they pass the regulatory test. Similarly, an off-ramp option, which re-opens the revenue cap for force majeure type events, is also proposed to be included in the new framework.

Origin agrees that it is important to avoid large potential errors in the setting of the ex ante cap, which would lead to significant windfall gains or losses to transmission companies, and therefore supports exclusions for relevant investments. We are further satisfied that an efficiency driver on such investments is maintained through application of the regulatory test.

That being said, in order to maintain appropriate forecasting discipline on transmission companies, any reopening of the revenue cap should only be allowed for events over which transmission companies have no control. Therefore, when considering whether to roll-in additional capital expenditure, or other unforeseen costs, during the regulatory period, Origin considers it important that the ACCC evaluates the extent to which the transmission company could reasonably have controlled the timing of such expenditures.

Incentive framework for operational and maintenance expenditures

Origin argued in its earlier submission that incentives for cost reduction should be set primarily on the basis of external benchmarks, ideally reflecting the costs of the most efficient firm in the market (such as reflected in frontier methods) or of an efficient hypothetical new entrant (replacement cost methodology). This has the effect of de-linking a transmission company's own costs from the revenues it receives, thereby discouraging it from providing inflated cost information to the regulator. Such an approach also reflects the outcomes of a competitive market, where prices and revenues track the costs of the most efficient competitor or new entrant, rather than the costs of particular firms themselves.

Unfortunately, in the absence of perfect information and foresight competitive market outcomes are impossible to predict ex ante, and thus must be estimated, which is clearly a subjective and contentious process. In addition, unlike the competitive textbook model, markets are rarely if every perfectly homogenous in the conditions facing each firm. Differences in the environmental, geographic, demographic, demand and political/regulatory legacy factors facing each transmission company makes any standardising of 'efficient' costs a perilous exercise. It is therefore unsurprising that regulators appear a long way off from implementing external cost benchmarks that take proper account of such unavoidable heterogeneity.

Consequently, Origin now acknowledges that setting regulated revenues or prices exclusively on the basis of external benchmarks is likely to impose significant uncertainty and financial risk on transmission companies with the resulting potential to deter network investment.

Benefit sharing

Origin supports the ACCC proposal for a rolling 'carry-forward' mechanism which allows transmission companies to retain the benefit of any savings for the same length of time regardless of when such savings are made. This would have the effect of limiting incentives for cost shifting within regulatory periods, which tends to occur in the current regime since cost savings made at latter stages of the regulatory period are held for a shorter time than those made at the beginning. We consider that retainment of cost savings for 5 years before they are passed through to access prices provides an appropriate balance between incentives for transmission companies to reduce costs and the sharing of those cost savings with consumers.

The cost of capital

Transmission companies should be able to earn an appropriate commercial return on their capital which promotes some certainty and predicability of revenue streams and encourages sufficient transmission investment in the NEM.

The key parameters underlying the cost of capital are subject to considerable uncertainty and imprecision, which means they should be conservatively set. The potential consequences of the allowable cost of capital having been set too low may be underinvestment in the transmission network increasing the likelihood of blackouts and load shedding. This may arguably be more serious (at least politically) then if the cost of capital had been set too high, which would increase transmission costs to consumers.

Origin considers the ACCC's approach to setting WACC parameters is appropriate. As well as being based on considerable historical precedent, international comparative research and in an environment where transmission companies are able to put there case and appeal if necessary, there is also little evidence to suggest that returns to date have been insufficient to maintain the viable operation of, and investment in, transmission networks.

If you wish to discuss this in any further detail, please contact myself or Julian Turecek on (03) 9652 5771.

Yours Sincerely,

Signed

Tony Wood
General Manager
Public & Government Affairs