Review of Draft Regulatory Principles for the Regulation of Transmission
TXU Response to ACCC – Draft Decision:

1. Introduction

TXU believes the long-term impact of regulatory error and uncertainty in relation to energy infrastructure is to deter both network and market based investment. Indeed, regulatory discretion under the legislative instruments that apply to gas and electricity networks creates uncertainty and risk. Whilst TXU acknowledge that not all regulatory arrangements can be determined upfront in a regulatory process, it supports the objectives of reducing regulatory uncertainty, which underpins the ACCC's Draft Regulatory Principles (DRP).

TXU believes that the ACCC should give serious consideration to the following points before finalising the DRP. These considerations are consistent with the rules in the National Electricity Code (NEC). TXU submits the ACCC will reduce the probability of regulatory error by providing due consideration to the following issues before it finalising the DRP for transmission.

They key points to consider include

- The ACCC has a requirement to have 'regard' to the factors in sect 6.2.2 in setting the revenue cap.
- The regulatory model submitted by TXU on the DRP has 'regard' to the factors in sect. 6.2.2 of the Code.
- TXU recommends a mandatory review of the regulatory test by the ACCC with public consultation for large augmentation investments (investments greater than $20M.)
- TXU regulatory model complies with Sect. 6.2.2 of the Code in excluding large investments.
- The ACCC's has a requirement to implement an incentive based regulatory regime under sect. 6.2.3 of the Code and ensure reasonable rate of return on efficient investment given efficient operating and maintenance practices.
- TXU's original submission on the DRP proposed a holistic regime. Piecemeal implementation causes difficulties and maybe worse than the status quo.

2. The ACCC has a requirement under sect. 6.2.3 of the Code to have 'regard' to the following factors in setting the revenue cap.

TXU has carefully developed a regulatory model that balances the needs of TNSPs and the other stakeholders including market based investors as well as customers given the ACCC's requirement in setting revenue caps under sect 6.2.2 the National Electricity Code (the Code). Section 6.2.3 of the Code set out a number of factors that the ACCC is to have regard to when setting a revenue cap. These include the need to:

- Provide TNSPs with incentives and opportunities to increase efficiency.
- Create an environment in which generation, energy storage, demand side options and network augmentations options are given due and reasonable consideration.
- Take account of any agreement for the sharing of risk between TNSPs and users.
- Provide a fair and reasonable risk adjusted rate of return to TNSPs on efficient investment given efficient operating and maintenance practices where assets are valued consistently with the principles of set out in clause 6.2.3 (d) (4) (i) –(v).
- Provide consistency and certainty in outcomes of regulatory processes over time, having regard to the need to balance the interests of TNSPs and users, the capital-intensive nature of the business, the need to minimise regulatory costs, and any previous regulatory decisions, including decisions made by jurisdictional regulators.

The regulatory model developed by TXU for the DRP carefully considers the requirements of sect 6.2.3 of the Code. As such, the ACCC should give it serious consideration before it releases the Final decision on the DRP.

3. TXU regulatory model for the DRP has regard for the elements in sect 6.2.3 of the Code.
TXU submits the regulatory model it has developed 'has regard' for all the requirements in sect.6.2.3 of the Code.

The model balances the need for greater investment certainty for TNSPs in setting their revenue caps, and gives due consideration to market based investors. In doing so, it provides TNSPs with more consistency and certainty whilst at the same time it provides due 'regard' to generators and demand side investors, all of which are critical parts of sect. 6.2.2 of the Code.

The TXU model consists of:

- A regime that supports the ACCC's position of 'locking in' TNSP asset values, provided that there is no evidence of significant deficiencies with the original jurisdictional asset values.
- A regime that supports ex-ante capital expenditure framework to provide greater investment certainty for TNSPs.
- A regime that provides for an efficiency carry over for capital expenditure and operating expenditure.
- A regime that supports the introduction of an incentive mechanism on capital highlighted by

    a) Support for the forecast of efficient capital expenditure using TNSP specific costs as the basis for determining capital expenditure forecasts for a regulatory term.
    b) A capex regime that excludes significant investments (ie a threshold value of greater than $20M) for large investment from the capital expenditure forecasts. TXU recommends that a mandatory review by the ACCC of the regulatory test as applied by the TNSP, before the network investment is undertaken.
    c) It supports a regime that includes "off ramps" to deal with changes in tax events and service requirements.

- A regime that moves to greater use of external benchmarks to determine operating and capital costs, provided these benchmarks take into account the specific circumstances of each business

4. TXU regulatory model complies with Sect. 6.2.3 of the Code in excluding large investments- (Investments greater than $20M.)

a) Investments greater than $20M
TXU believes that an important component to the regulatory model put forward to the DRP is the need to exclude large projects from the capital expenditure forecast over the 5-year term. It has put forward its own threshold for excluding these large projects, and notes that the ACCC has adopted a different threshold. [1] Whilst the criteria for exclusion of large projects is different in the regulatory model submitted by TXU, the principle is simular.

Whilst the regulatory test will be applied by TNSPs on the large excluded assets, it has not yet reconciled who will ensure that the regulatory test has been applied appropriately in accordance with the Code. The Draft decision is silent on this issue.

TXU believes that it is an important component of the incentive properties of the capital expenditure framework and its effects on networks users, is to clarify how the regulatory test will apply to large projects. Thus, TXU believes that the large projects excluded from the revenue cap should be subject to a mandatory independent review of the operation of the regulatory test. The ACCC as an economic regulator is well placed to undertake this review.

[1] ACCC excludes large projects on the basis that these large projects may create a regulatory error of larger than 10% on the revenue cap.

Whilst the ACCC has not yet determined how the regulatory test fits into the DRP, TXU believes the regulatory model it has developed does this and should be considered seriously.
TXU believes that the ACCC has a responsibility under sect 6.2.3 to ensure that in setting a TNSP's revenue cap that due consideration is given to

> *"Create an environment in which generation, energy storage, demand side options and network augmentations options are given due and reasonable consideration*".

Our model reconciles the regulatory test and capital expenditure framework.

TXU notes two key characteristics of the capital expenditure framework in the DRP include

- The exclusion of large projects from the revenue cap, where there is a probability that by including the large product it will cause a regulatory error of > 10% on the cap.

- The inclusion of off ramps for deal with changes in tax events and changes in service requirements.

TXU acknowledges that both of these elements of the capital expenditure framework will provide greater investment certainty for TNSPs. However, it is concerned that that the large assets undertaken outside the revenue cap will be subject to a self assessed regulatory test by TNSPs in its current state. This then implies risk for non-network investors that in-efficient investments will distort the market.

b) Market Failure Provisions in the regulatory test
An important part of TXU's submission on the capital expenditure framework in the DRP, as it applies to large investments, is the need to maintain the "Market failure Provision" which forms part of the regulatory test. TXU notes the ACCC has abolished the market failure provisions in the "Review of the Regulatory test – Decision."

The ACCC argues interested parties have misunderstood the market failure provisions in the regulatory test submissions and removed it entirely. However, TXU has privately argued to the ACCC that by abolishing the market failure provisions, this will encourage the development of augmentations and interconnectors forecast over longer time horizons crowding out unregulated investments that are inherently invested with a short lead-time. TXU believes that the ACCC is able to deal with this as part of its capital expenditure framework in the DRP. This could be achieved by limiting the acceptance of excluded large projects to those where construction begins no more than 12 months from the date of acceptance.

5. The ACCC's requirement to implement an incentive based regulatory regime under sect. 6.2.2 of the Code and ensure reasonable rate of return on efficient investment given efficient operating and maintenance practices.
In administering the regulatory regime, the ACCC is required under clause 6.2.2 of the Code, to seek to achieve a number of objectives including:

> " *An incentive based regime which shares any efficiency gains equitably between users and TNSPs and which provides for a sustainable commercial revenue stream including a fair and reasonable rate of return on efficient investment given efficient operating and maintenance practices."*

The ACCC's ex-ante capital expenditure regime is highlighted by two elements:

- The exclusion of large capital projects that potentially impact the incentive properties of the revenue cap creating a regulatory error of greater than 10%.
- An off ramp regime for a changes in tax event or changes in service standards.

Where large investment projects are taken outside of the revenue cap, then the ACCC still has responsibility under sect. 6.2.2 to ensure these assets recover:

> " *a reasonable rate of return on efficient investment given efficient operating and maintenance practices"*

TXU believes that the ACCC can only achieve the objective of ensuring the large excluded investments are efficient with efficient operating & maintenance practices, is to subject them to an independent efficiency test. That is, the application of the regulatory test on these large excluded projects should be subject to regulatory audit by the ACCC on an ex-ante basis. This would ensure that these assets

- Recover a reasonable return with efficient operating and maintenance practices.
- TNSps get ex ante sign off on the efficiency of these large excluded projects improving investment certainty.
- Bring this process in line with sec 8.21 of the Gas Code where there is a process for getting a sign off from a regulator to ensure that project undertaken in economically feasible and efficient.
- Receive a level of diligent assessment commensurate with the size of regulated funds required to repay.

6. TXU's original submission on the DRP proposed a holistic regime. Piecemeal implementation causes difficulties and maybe worse than the status quo.

TXU has developed a regulatory model for the DRP after careful 'regard' to the consideration of sect 6.2.3 & of the Code when setting the TNSPs revenue cap. It is required to give due consideration to TNSPs moving forward into a new regulatory period, whilst at the same time having due consideration for the needs of market based investors.

TXU believes that it has carefully developed a regulatory model that complies with the key elements of sect. 6.2.3 of the Code. As such, the ACCC should give it serious consideration.

The removal of optimisation risk is a matter of concern to market based investors such as TXU, however we accepted this as a reasonable outcome as long as projects with a large market impact (> $20million) were subject to independent ex-ante review.

The model submitted to the ACCC by TXU should be accepted in total if it is to deliver its maximum benefits. TXU withdraws its support for the model if all the parts of the model are not accepted by the ACCC.

7. ACCC's Use of 10% threshold vs $20 million threshold

As stated, TXU believes that threshold concept concurs with our $20M suggestion. Undoubtedly this is superior to the inter/intra regional model also proposed. However, we feel the absolute value cap ($20Million) is better than 10% because

- This represents the true level of regulated funds that is being invested by on behalf of the customer
- Reflects the type of projects that impact market investors and are thus deserving of independent scrutiny
- Is not distorted by the relative size of the TNSP. Clearly 10% of Powerlink capital expenditure program is > than 10% of Murraylink's.

8. Conclusion

So in summary, the key points that TXU believe the ACCC should consider before the Final Decision of the DRP are:

- The ACCC has a requirement to have 'regard' to the factors in sect 6.2.2 in setting the revenue cap.
- The regulatory model submitted by TXU on the DRP has 'regard' to the factors in sect. 6.2.2 of the Code.
- TXU recommends a mandatory review of the regulatory test by the ACCC with public consultation for large augmentation investments (investments greater than $20M.)
- TXU regulatory model complies with Sect. 6.2.2 of the Code in excluding large investments.
- The ACCC has a requirement to implement an incentive based regulatory regime under sect. 6.2.3 of the Code and ensure reasonable rate of return on efficient investment given efficient operating and maintenance practices
- TXU's regulatory model should be adopted in its entirety if it is to have maximum impact. If it is not, then TXU withdraws it in its entirety.

TXU's recognises that electricity generation and transmission are in competition. As such, it is important to ensure that the regulatory environments for both these remain competitively neutral. TXU has asked the ACCC consider some key issues as part of the DRP in this paper to ensure that competitive neutrality is a key feature of the regulatory regime in transmission. If these points are not considered then TXU agrees with the ACCC on p14 of the DRP Final Decision that states

> " *In order to sustain on-going investment in electricity generation (especially in the importing regions) it is therefore critically important to ensure that electricity transmission investments are economically efficient. In the absence of controls on transmission investment, inefficient regulated investment in transmission network augmentation could crowd out efficient private investment in generation*."

Regards

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