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Comments on ACCC Draft  
Decision on South Australian  
Transmission Revenue Cap 2003-2007/8

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TransGrid Submission

*11 October 2002*

## 1 Introduction

TransGrid would like to thank the ACCC for the opportunity to comment on the Draft Decision on South Australian Transmission Revenue Cap 2003-2007/8. It goes without saying that the decisions made by the ACCC in relation to this matter will have a significant impact on the customers of South Australia and the business direction of ElectraNet SA.

What is probably not fully appreciated are the flow on implications for the future role of transmission in the NEM, including the development of much needed interconnection capability and improved ability to trade freely across the NEM. If the ACCC uses regulated returns that are too low in arriving at its revenue caps, it will force equity capital out of the regulated transmission sector and encourage the proliferation of network constraints.

It is acknowledged that the ACCC is in the unenviable position of operating under a Code that does not always provide clear guidance on these matters, as well as having to anticipate key aspects of Government policy on the future role of transmission. Nevertheless, it is TransGrid's contention that there is enough clarity, both within the Code and in publicly available policy positions, to lead the ACCC to a more supportive position in relation to regulated transmission investment in the final revenue determination for ElectraNet SA.

This submission expands on the Code and policy guidance available to the ACCC, the required level of regulated returns for ElectraNet, and the ACCC's decision to exclude the Robertstown to Monash and Monash to the SA – NSW border transmission developments. It also seeks greater clarity from the ACCC on the principles it is adopting in relation to easement valuations, service standards, and the capitalising of refurbishment costs.

## 2 The Requirements of the Code

The Code (Clause 6.2.3 (a)) requires the ACCC to be 'consistent with the regulatory principles set out in clause 6.2.2'. These principles include the requirement that the transmission revenue regulatory regime, as administered by the Commission, must seek to achieve outcomes that:

- Are efficient and cost effective.
- Foster efficient investment, operation, maintenance and use of network assets.
- Promote competition.
- Are reasonably accountable, transparent and consistent over time.

It is acknowledged that the promotion of competition could be interpreted in a range of ways without regard to the wider policy and Code context. It is TransGrid's contention that competition in upstream and downstream markets is what was primarily intended by COAG and this is where the most significant benefits accrue to customers.

The ACCC seems to recognise this too when it states:

*'The lack of interconnection between regions has been raised as one aspect of the NEM's design that contributes to circumstances where market power can be used. The limited interconnection between regions often leads network constraints and the separation of the NEM into regional markets. When regions are isolated there is less competition in generation within the region and it is more likely that generators will be in a position to exploit their position in the market and influence spot prices'.<sup>1</sup>*

In a recent presentation to the Annual Conference of Economic Society of Australia, Professor Frank Wolak (Chairman, Market Surveillance Committee California ISO) acknowledged that 'market power [is] common to all markets' and that 'all electricity markets [are] susceptible to

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<sup>1</sup> 'Submission to the COAG Energy Market Review, Reforming Australia's Energy Markets', pg 67, ACCC, May 2002.

exercise of market power<sup>2</sup>. Wolak argued that ... 'logic implies a strong need for pro-actively managed and regulated transmission network to support a competitive generation market.'<sup>3</sup>

### 3 Policy Guidance

There is ample evidence of Government positions on the promotion of investment of essential infrastructure generally, and electricity transmission specifically. The Commonwealth Government's response to the Productivity Commission's Review of Part IIIA of the Trade Practices Act stated clearly that the ACCC must have regard for the following principles:

"(a) that regulated access prices should:

- (i) Be set so as to generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services; and
- (ii) Include a return on investment commensurate with the regulatory and commercial risks involved."<sup>4</sup>

In the communiqué following the NEM Ministers Forum on 19 July 02 the NEM Ministers determined that:

"the optimal framework for transmission development should:

- promote economic efficiency;
- maintain power system reliability at least cost (eg. reduce generation costs);
- maintain system security at least cost (eg. minimise ancillary service costs);
- avoid inefficient regional price differences, including assisting in addressing market power issues, and
- facilitate electricity trading between regions."<sup>5</sup>

Accordingly, there is little doubt that both the Commonwealth and the States are providing a policy context for the ACCC that includes encouraging efficient transmission investment, particularly where it is related to promoting competition in the wider electricity market by relieving transmission constraints. To achieve this the ACCC must clearly demonstrate that the regulated returns adopted in the ElectraNet decision are sufficient to encourage this to occur. It also creates a policy context supportive of including the Monash to Robertstown transmission development in the allowed capital expenditure profile.

### 4 Need for a Higher Level of Regulated Rate of Return

While the Code and policy context provides some guidance the ACCC still faces a challenging task in determining, with confidence, the correct balance between limiting the level of monopoly rent available to transmission businesses while ensuring that there is sufficient incentive to encourage efficient transmission investment. Nevertheless, it is increasingly apparent that, when faced with doubt, it is appropriate for the ACCC to err in favour of promoting transmission development.

The ACCC has not provided sufficient evidence in its draft ElectraNet SA Revenue Determination that it has achieved this outcome. In particular, the reasons why the ACCC has not adopted the publicly stated positions of eminent experts in this field have not been outlined in the draft determination. At a recent public forum on the WACC issue (held June 2002) in Melbourne,

<sup>2</sup> Wolak, F., *Using Economic Analysis to Improve Electricity Market Design*, 31<sup>st</sup> Australian Conference of Economists and Business Symposium, Adelaide 2002

<sup>3</sup> *ibid*

<sup>4</sup> Commonwealth Treasurer 2002, *Government Response to Productivity Commission Report on the Review of the National Access Regime* [On-line]. Available <http://www.treasurer.gov.au/tsr/content/NationalAccessRegime.asp>

<sup>5</sup> Attachment A of the NEM Ministers Forum Communiqué issued following the 19 July 02 NEM Ministers Meeting

academics and industry specialists argued that the detriment arising from setting the regulated returns too low was greater than the detriment arising from setting them too high. Accordingly, to the extent there is doubt about the value to be attributed to a parameter in the CAPM model, regulators should err on the high side.

For example, the consensus of speakers at that forum was to adopt a 10-year bond rate as the basis for determining the risk free interest rate variable in the model for determining WACC, in conjunction with a market risk premium of 6%. If the ACCC was to err on the side of promoting investment it would not pass over such a recommendation without providing a clear, transparent, and expert basis for this position. The minimal supporting arguments provided by the ACCC in the draft decision on this matter fall well short of such a standard.

In addition, reference to international experience suggests that the levels of regulated return are too low in Australia, not too high as suggested by customer representatives. Indeed, in places where returns appear to be lower there is ample evidence of the withdrawal of equity capital from regulated infrastructure.

Cragg et al<sup>6</sup> argues that the rates of return required by a stand alone transmission business in the deregulated electricity markets in the US is higher than applied before deregulation. On the basis of a survey the authors propose that a target return on equity of 13.4% is appropriate compared with the 11.4% target used in draft ElectraNet revenue determination.

The analysis provided by customer representatives does not include accompanying analysis of the impact that these reported low returns are having on the level of equity capital being made available for infrastructure investment.

At the International Grid Conference in London during May this year, the Vice Chairman of NM Rothschild, Mr Keith Palmer, analysed the current capital structure trends of regulated utilities in the UK. Palmer cited, among others, that the drivers for regulated utilities to pursue high debt to equity ratios included to ‘...Reduce equity exposure to low regulated returns’<sup>7</sup>. Palmer illustrated recent UK developments of water companies highlighting that:

- *The market perception that the allowed return on regulated assets is too low*
- *There was a “flight of equity”*
- *There is a move to more aggressive debt structures*
- *100% debt financed models<sup>8</sup> are emerging in some cases as equity capital is removed*

Finally, it is generally acknowledged that there is a lack of adequate transmission investment in overseas markets such as the US<sup>9</sup> and New Zealand, and that transmission congestion is contributing to high prices in these markets, enhancing price volatility risk, and even threatening longer term system reliability. Accordingly, the adequacy of returns in overseas contexts in encouraging much needed development needs to be considered cautiously.

For the ACCC to demonstrate that it is meeting the emerging policy requirements it must explicitly address expert analysis that returns are too low and, in so doing, use international comparisons with care. These comparisons must include adjustments for real interest differentials between countries, and consider whether the returns in those markets are sufficient to attract equity capital and promote transmission development. The draft decision does not set out these aspects of the ACCC’s analysis in support of the balance struck by the ACCC between restricting ElectraNet’s monopoly rents and promoting transmission development.

<sup>6</sup> Cragg, M., Lehr, W. and Rudkin, R., 2001, *Assessing the Cost of Capital for a Standalone Transmission Company*, *The Electricity Journal*, January–February pp. 80-88

<sup>7</sup> Palmer, K., *Presentation on Capital Structure of Utilities*, International Grid Conference, London 2002 – copy available on request.

<sup>8</sup> *ibid*

<sup>9</sup> “Clogged Grid Hampers US Power Market Plan” [On-line]. Available <http://www.utilityhq.com/ezine.asp>

## 5 Inclusion of South Australian Parts of SNI in the Regulated Asset Base

TransGrid recognises the challenges facing the ACCC in the decision it must make about whether or not to include the costs of the Monash to Robertstown augmentation, and the transmission line from Monash to the South Australian border, in ElectraNet's revenue determination.

At face value the arguments about these matters appear to involve the ACCC in attempts by opponents of SNI to prevent this project from proceeding. It is a matter of record that Hydro Quebec's subsidiary, Murraylink Transmission Company, has appealed the NEMMCO decision that the SNI project is justified in accordance with the regulatory test. It is also a matter of record that a number of generators and gas businesses in the Victoria–South Australia region have supported this appeal. The opponents of this project have demonstrated a high level of motivation to prevent this project, as evidenced by the extensive engagement of legal teams and expert witnesses in the SNI appeal. This is also consistent with theoretical expectations of participant behaviour, as outlined by Greg Houston in a paper<sup>10</sup> presented to the Australian Conference of Economists in Adelaide on 3 October 02.

In this context it is also not surprising that NRG, as an owner of significant South Australian generation capacity, has argued in their submission to the ACCC that this project should not be included in the ElectraNet SA revenue determination. All these parties are fully aware that, for investment to occur in a regulated interconnection, such as SNI, the costs of this investment must be recognised in either TransGrid's or ElectraNet's revenue determination. Their opposition to the project's inclusion in the ElectraNet determination is entirely understandable given the fiduciary duty of the management of these companies to the interests of their shareholders.

The draft decision proposes to exclude two proposed investments by ElectraNet SA which form part of SNI.

These projects (Projects 1.52 and 1.36) effectively make up the South Australian component of SNI. While TransGrid is the proponent for this project, TransGrid and ElectraNet SA have agreed that ElectraNet SA would construct the Robertson to Monash portion of SNI. TransGrid and ElectraNet SA are currently discussing whether ElectraNet SA should construct the portion of SNI between Monash and the South Australian border although this issue has yet to be resolved. This is similar to the arrangements adopted in relation to the SNOVIC 400 Project where VenCorp was the proponent of that project even though many of the assets being constructed form part of TransGrid's network.

TransGrid notes that there is nothing in clauses 6.2.2, 6.2.3 or 6.2.4 of the Code which requires that only the party which applied to NEMMCO for a determination that a new interconnector is justified should be the party to construct the assets which form part of that interconnector.

Similarly, clauses 5.6.5 or 5.6.6 of the Code do not require that the party which refers its connection application to NEMMCO under clause 5.6.6 is the only party which undertakes work in respect of the project. In contrast, clause 5.6.6(d) clearly envisages that a number of networks will need to be augmented as part of a new interconnector. Finally, while the regulatory test refers to a "proponent" for a project, the test does not require that this party is the only party to construct a project. TransGrid notes that none of the parties to the recent National Electricity Tribunal proceedings disputed that this is the case.

TransGrid is concerned that Meritec and, based on the Meritec report, the ACCC, propose to exclude these projects based on Meritec's interpretation to the Code and regulatory test. TransGrid considers that the interpretation of these documents is essentially a legal issue. In TransGrid's view, Meritec is not competent to interpret the Code for the ACCC and it is not appropriate for it to do so.

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<sup>10</sup> Houston, G., *Efficient Electricity Transmission: Where to From Here?*, 31<sup>st</sup> Australian Conference of Economists and Business Symposium, Adelaide 2002

However, in relation to the points raised by Meritec, TransGrid notes as follows:

- (a) NEMMCO determined that SNI satisfied the regulatory test and maximised the net market benefit with the project being in service in the year 2004/05;
- (b) while NEMMCO's determination is the subject of an application to the National Electricity Tribunal, the determination is effective and the ACCC is required by the Code to treat it as such; and
- (c) SNI as approved by NEMMCO runs via Monash.

As mentioned above, NEMMCO's determination regarding SNI was that, in accordance with the regulatory test, it was justified in 2004/05. One of the benefits which NEMMCO took into account was the deferral of the need to augment supply to the Riverland (other than the utilisation of network support from Murraylink). Utilising analysis carried out by Meritec on behalf of the ESIPC, NEMMCO determined that this benefit arose in 2007/08. However, while the Riverland deferral benefit arose in 2007/08, NEMMCO determined that the net market benefit of SNI was maximised if SNI was in service in 2004/05. Hence both projects should be included in TransGrid's revenue cap from that date although the section from Monash to the South Australian border should only be included on the basis that the capital expenditure would only be recognised if ElectraNet builds this portion of the project.

TransGrid cannot identify the basis for the argument that SNI, as approved by NEMMCO, does not run via Monash. This argument is simply wrong.

On 27 October 1998, TransGrid wrote to NEMMCO requesting NEMMCO to consider a proposed interconnector between NSW and South Australia. The proposal was said to involve

*"the construction of a 275kV transmission line from Buronga to Robertstown and supporting works in NSW and South Australia".*

In 1999, TransGrid released a community consultation paper on the available routes for SNI. This document stated:

*"Because of its location, the SNI transmission line can be of particular value to consumers in the Riverland area. Growth in demand for electricity in this area has also been high, and ElectraNet SA has commenced planning to reinforce supply to the area. Rather than having to bring additional supply from a remote location, provision has been made to tap into the SNI line to provide this reinforcement, markedly reducing both costs and impacts on communities and the environment.*

In its report to the IOWG of 30 March 2001, TransGrid stated:

*"The actual line route will not be determined until completion of the environmental assessment process. ... The project provides a direct connection from the NSW main system to the South Australian main system at Robertstown. The SNI line is expected to pass close to the Berri area and a connection to the new Monash Substation at Berri is possible. This will allow the Riverland 132kV transmission system to be supported with minimal cost and impact."*

The Environmental Impact Statement (EIS) for SNI, which TransGrid recently released, is based on the route of SNI going to Monash.

Finally TransGrid notes that NEMMCO included the deferral of the need to augment supply to the Riverland as a benefit from SNI. To do this if SNI did not run via Monash would simply be nonsensical.

To assist the Commission in this regard, TransGrid has asked NEMMCO to confirm that its decision included these developments as part of the approved SNI project. This confirmation will be provided to the ACCC as soon as it is available.

## 6 The Need to Clarify Revenue Setting Principles

The ElectraNet SA draft determination raises a number of potentially important revenue setting principles in the following areas:

(a) Easement valuations

TransGrid notes that the ACCC current methodology in the valuation of easements, and as outlined in the Draft Statement of Regulatory Principles (DSRP), is based on regular revaluations of easements within the regulatory asset base (RAB) in line with DORC based valuations. To prevent windfall gains to the TNSPs resulting increases in the RAB would be treated as 'negative depreciation'. TransGrid further notes that in TransGrid's inaugural revenue determination, the Commission raised the possibility of a transition path to full ODRC valuation for easements (however, a mechanism was required to control windfall gains realised by TNSPs because of increases in underlying property values).

In the ElectraNet SA draft decision, the Commission appears to propose a new approach by appearing to suggest that the Commission prefers an indexed historical cost valuation of easements. While not necessarily disagreeing with the Commission's new approach, (depending in part on how historical cost is defined in this calculation) TransGrid would encourage the Commission to carry out specific rounds of consultation on changes to important revenue setting principles such as this. This process is preferred, rather than having these matters evolve within revenue determinations for individual transmission businesses.

(b) Capitalisation of refurbishment costs

In a similar vein to TransGrid's concerns about easement valuation principles TransGrid supports the concerns raised by Powerlink regarding the apparent change in relation to capitalisation of refurbishment costs. The principles used by the ACCC in deciding to move large amounts of refurbishment costs from ElectraNet SA's operating expenditure to their allowed capital expenditure are not clear. At face value a different approach appears to have been taken in the ElectraNet SA draft determination to that in the Powerlink and earlier determinations. TransGrid believes that there is merit in relying on accounting standards on the basis that this provides consistency between TNSPs and over time, and between regulatory accounts and financial accounts. It is certainly not appropriate to be making changes to principles such as these 'on the fly' from one determination to another.

(c) Setting of Performance Incentives

TransGrid believes that if reliability performance targets were set at levels at or near best practice then improvements beyond this would be much more difficult to achieve than declines in service levels. Using this approach results in a penalty scheme not an incentive scheme. TransGrid maintains that transmission companies should be rewarded for achieving and maintaining 'best practice' and only should only be penalised when performance falls below 'acceptable practice'.

TransGrid also warns about creating 'double jeopardy' for transmission companies. This would arise when investment needed to deliver reliability and reduced congestion was prevented by low levels of regulated return and non-inclusion of these investment projects in the regulated asset base, only to see the transmission companies penalised when service targets were not achieved.

## 7 Summary

The ACCC's revenue determination in relation to ElectraNet SA is not just important to ElectraNet SA, but has implications for the future role and function of transmission in the NEM.

By establishing regulated returns that clearly provide an incentive for transmission investment, the ACCC will ensure removal of an important impediment to delivering the strong national transmission grid needed for effective competition in the NEM wholesale market. By including the costs of capital projects in the ElectraNet revenue cap that have been shown to pass the regulatory test, such as the parts of SNI within South Australia, the ACCC will remove another impediment. On both counts TransGrid seeks the ACCC's support in arriving at its final determination.

Where there is doubt the ACCC should ensure that the issues involved are transparently and thoroughly considered before coming to a decision, or at least ensure that there are adequate processes in place to ensure that this occurs. If doubt still remains, Code requirements, and emerging policy from both Commonwealth and State Governments, appear to favour decisions that err on the side of enhanced transmission development.

In relation to the parts of SNI within South Australia, namely the Robertstown to Monash line, and the line between Monash and the South Australian border, there is no doubt that these were part of the project approved by NEMMCO in relation to the SNI interconnector. They are also needed to deliver the benefits which have been demonstrated to flow from SNI as well as to ensure timely delivery of reliability to the Riverland area and should therefore be included in the ElectraNet SA determination subject to ElectraNet SA constructing the section between Monash and the South Australian border. TransGrid has provided detailed evidence on both counts in *Attachment A* and would be pleased to meet with ACCC staff or their advisers to answer any questions on this matter. To assist further NEMMCO has been approached to provide independent formal verification of that the approved SNI project ran via Monash.

Finally, we encourage the ACCC to develop revenue setting principles in a clear and open manner and to apply these principles in a relatively consistent manner from one determination to another. In this regard, further general consultation on the principles applying to easement valuations, capitalisation of refurbishment costs, and setting of performance incentives would seem appropriate.



## Attachment A

### Approved SNI Project Does Include the Monash to Robertstown Transmission Projects.

TransGrid's connection application to ElectraNet SA (18<sup>th</sup> October 1999) and application to NEMMCO (6<sup>th</sup> March 2000) for the SNI evaluation to be recommenced both referred to possible connection to Monash (or New Berri).

NEMMCO's Final Determination on SNI and the IRPC's Stage 2 report both make several references to SNI supporting Riverland. In fact, the determination included an allowance of \$25M benefit for support to Riverland as a benefit from the project. It is clear that this benefit was based on the avoided costs if constructing a Robertstown to Monash line reduced by the additional costs of surplus at Monash to connect the line to the Monash sub-station.

Both the IRPC Stage 2 Report and NEMMCO's Final Determination are available on NEMMCO's web site. References to mentions of Riverland support are:

IRPC Stage 2 Report (26<sup>th</sup> October 2001)

- 2.2 on page vi
- 2.2 on page vi
- 3.1.9 on page 9
- 3.2 on page 10
- 3.2.7 on page 11
- 3.3.1 on page 12
- 5.3.2 on page 17
- 1.11 page 44

NEMMCO's Final Determination (6<sup>th</sup> December 2001)

- (4)(g) on page 2
- 4.8 on page 23

The IRPC, their consultant ROAM and by finally NEMMCO, allowed a benefit of \$25 million for support to the Riverland area in the calculations. The South Australian Electricity Supply Industry Planning Council (ESIPC) advised the IRPC/NEMMCO that a figure of \$25M benefit was attributable to SNI for Riverland reinforcement.