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Mr Sebastian Roberts
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Australian Competition and Consumer Commission
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Sebastian

Dear Mr ~~Roberts~~

TRANSGRID REVENUE CAP DECISION 2004 TO 2009 – SHARING OF EFFICIENCY GAINS AND CONSISTENCY WITH THE NATIONAL ELECTRICITY CODE

TransGrid is keen to move to an operating expenditure incentive regime that provides a reasonable opportunity for TransGrid to share in the benefits of efficiency improvements with customers on an equitable basis. I believe that it is the Commission's intention to achieve this outcome. I also note that in TransGrid's response to the Commission's Draft Decision on TransGrid's revenue cap for 2004 – 2009 TransGrid expressed concerns as to whether such equitable sharing was feasible, given the targets set by the Commission in that Draft Decision. Recent suggestions by Commission staff to apply the efficiency carry over scheme contained in the Commission's recent Draft Decision on *The Statement of Principles for the Regulation of Electricity Transmission Revenues* do not appear to alter this position.

It is in this context that TransGrid has considered the Commission's overall approach to Opex efficiency as outlined in the Commission's Draft Decision regarding TransGrid's revenue cap for 2004-2009 and its recent Draft Decision on *The Statement of Principles for the Regulation of Electricity Transmission Revenues*. In particular, we have considered whether the Commission's approach, if applied to TransGrid in accordance with these Draft Decisions, is likely to be consistent with the relevant provisions of the National Electricity Code (**the Code**). This assessment has included economic advice from n/e/r/a and legal advice from Gilbert + Tobin.

As a result of this assessment we are concerned that the Commission's Opex efficiency targets are unlikely to be consistent with the provisions of 6.2.3 of the Code, since:

1. The ACCC is only empowered by the Code to make a decision relating to the allocation of efficiency gains provided it is an "equitable allocation" of efficiency gains. s6.2.2 of the Code states that:

   "The transmission regulatory regime to be administered by the ACCC pursuant to this Code must seek to achieve the following outcomes:... an incentive based regulatory regime which provides for an <u>equitable allocation</u> between Transmission Network Users and Transmission Network Owners and/or Transmission Network Service Providers (as appropriate) of efficiency gains reasonably expected by the ACCC to be achievable by the Transmission Network Owners and/or Transmission Network Service Providers".

2. The ACCC would therefore need to assure itself, and explain to interested parties, how its decision results in an equitable allocation of efficiency gains between TransGrid and its customers, in circumstances where, on the basis of NERA's economic analysis:

(a) TransGrid's effective allocation of efficiency gains under the proposed opex regime is most likely to be negative, with a lesser possibility of zero, and is very unlikely to be positive;

(b) the likelihood of the allocation of these gains to TransGrid being negative is increased by the fact that the ACCC's opex benchmark implicitly includes a greater efficiency gain than the ACCC's explicit target of 2% pa;

(c) if TransGrid achieves the Commission's 2% efficiency gain target, the highest allocation of gains to TransGrid will be 0%, and; where efficiency gains deviate from the expected level (2%), the ACCC's Draft Decision has an implicitly asymmetric allocation of efficiency gains – with TransGrid being heavily penalised for not meeting the 2% target but being relatively moderately rewarded for exceeding it.

2.2 The phrase "equitable allocation" is not defined in the Code, but it is clear from its context that it:

(a) envisages an apportionment of efficiency gains between the TNSP and its customers. The ACCC's "allocation" is most likely to result in no allocation of gains to the TNSP. It is difficult therefore to construe the ACCC's draft decision as an "allocation" at all;

(b) in any case, the Code requires that apportionment be made on the basis of a standard of equity or "fairness". This is evident from the fact that other sections of the Code specifically refer to economic efficiency in a variety of ways – eg, *"efficient and cost effective"* (s6.2.2(a)), and *"efficient level of investment"* (s6.2.2(d)). This view is also supported by the ACCC's decision in accepting the Code as an Access Undertaking under s44ZZAA of the TPA, where it states that: *"it is generally recognised that attempting to achieve both efficiency and equity objectives through a single pricing policy involves a tradeoff. An efficient pricing regime will generally have undesirable equity consequences while an equitable pricing regime will generally have undesirable efficiency consequences".*

3. It is not clear from the ACCC's Draft Decision whether it has turned its mind to the question of whether the proposed allocation is indeed "equitable". It is difficult in any case to see how an allocation which is likely to be 0% or negative to the TNSP is "fair" or results in "equality".

4. We therefore consider that the Commission's proposed approach to the Opex efficiency gain target is likely to be inconsistent with the relevant Code provisions since it will not produce an equitable allocation of efficiency gains.

5. The Commission should therefore consider the alternative approach to Opex proposed by n/e/r/a which includes:

(a) assuming that the ACCC's proposed efficiency carryover mechanism is implemented;

(b) all implicit efficiency gains should be removed from the opex benchmark; and

(c) an efficiency target incorporated into the ex ante opex benchmark that results in a positive and equitable allocation of the expected 2% efficiency gain to TransGrid (where a 0.4%pa target would allow TransGrid to receive a 30% allocation of the 2% expected efficiency gain).

I am confident that you want to see an effective and appropriate efficiency incentive framework applied to TransGrid. Unfortunately, even the adoption of n/e/r/a's proposals does not appear to achieve this outcome. In particular, I note that n/e/r/a have only considered the sharing of gross efficiency gains in coming to these recommendations. An incentive based regulatory regime needs to provide sufficient incentives to undertake expenditure to achieve an efficiency gains, as well as providing for an equitable sharing of the net gains (gross efficiency gains less the costs of achieving those gains). Accordingly, we have asked n/e/r/a to examine this aspect of the regime more closely in order to refine our proposals appropriately. In the meantime I ask that you refer this matter to your staff for a considered and timely response in order for this matter to be progressed constructively ahead of TransGrid's final revenue cap decision. To assist in this regard, I have attached the advice from n/e/r/a in full to this letter.

Yours sincerely

Kym Tothill

Mr Kym Tothill
GENERAL MANAGER/
CORPORATE DEVELOPMENT

Attach: