TransGrid

ACCC Preliminary View on Murraylink's Application for Conversion

TransGrid's Submission to the ACCC

18 July 2003

ACCC's Preliminary View on Murraylink's Application for Conversion to Regulated Status

TransGrid's submission

TransGrid would like to thank the Australian Competition and Consumer Commission (ACCC) for providing the opportunity to submit these comments on the ACCC's Preliminary View dated 14 May 2003 on Murraylink's application for conversion to regulated status.

Executive Summary

TransGrid has four main submissions to make about the ACCC's Preliminary View:

- The process proposed and used by the ACCC in its Preliminary View for evaluating Murraylink's application for conversion does not support the main purposes of the transmission network planning regime in the National Electricity Code of promoting "efficient" transmission investment in the National Electricity Market (the **NEM**);

- There a number of deficiencies both in the methodology and technical analysis of Murraylink's application for conversion relied upon in the ACCC's Preliminary View, which need to be addressed in order for the ACCC to determine a robust regulatory asset value for Murraylink if it decides to allow Muraylink's application for conversion for such analysis;

- A sound knowledge of the of the NEM power system is necessary to effectively carry out the required technical analysis of Murraylink's application for conversion. TransGrid believes the body best qualified to carry out such a technical analysis is the NEM Interconnector Options Working Group and that any application for conversion under clause 2.5.2(c) of the Code including Murraylink's current application should be referred to the IOWG;

- In order to ensure regulatory consistency, and a level playing field for all regulated transmission investments in the NEM, the approach adopted by the ACCC in the Preliminary View to issues such as the calculation of WACC, asset valuation methodology, cost pass through and length of regulatory period, must also apply equally to the determination of the regulated revenue cap of existing Transmission Network Service Providers

TransGrid also retained NERA to review and provide comments on the Preliminary View. NERA's report is attached as an integral part of this submission.

A The ACCC's Approach to Evaluating Murraylink's Application for Conversion

Regulated transmission delivers greater market benefit in the NEM

During the current debate on the deficiencies of the NEM regulatory framework and, in particular, on the lack of prudent investment in transmission, it has become evident that many economists, policy makers and TNSPs firmly believe that regulated transmission is the most efficient form of investment for transmission in the NEM.

The ACCC's Preliminary View supports TransGrid's long held conviction that a regulated TNSP delivers greater market benefits than an MNSP, and the view that regulated transmission is the most cost effective form of transmission investment in the NEM. This issue is addressed further in the attached NERA Report.

Proposed process lowers the 'bar' for conversion of MNSP to regulated transmission

TransGrid is concerned that the process adopted in the Preliminary View sets the hurdle for conversion too low and this, in turn, will actually encourage "inefficient investment" in transmission.

The Preliminary View process appears to ask only the following two questions:

- Does the MNSP provide a prescribed service?
- Does it have net market benefits?

TransGrid believes there are two key steps missing in this process. The first two questions that should be answered are:

- Has there been any material change in market design since the decision to invest was made?; and
- Has this change had any direct and material impact on the MNSP's commercial viability?

These questions are essential in order to align the conversion process to the intent of the "Safe Harbour" provisions of the Code being used to trigger the conversion process in the first place.

Code 'Safe Harbour' provisions relating to conversion of MNSP to regulated status

The "Safe Harbour" provisions of the Code were designed to protect an MNSP investor against dilution in commercial viability of the MNSP as a result of market design deficiencies that were not evident at the time the MNSP made its decision to invest and against unforseen changes to market design. This is clear from the commentary by the NECA's working group that drafted these provisions and is discussed in more depth in NERA's report.

The commercial viability of Murraylink has always been questionable. While the actual cost of Murraylink has never been made public, MTC has stated in its submission that this cost was greater than $176M.

Assuming an investment of $176M in a hypothetical entrepreneurial interconnector between Victoria (Vic) and South Australia (SA); one can do a simple "back of the envelope" calculation on the commercial viability of such an investment. Assuming a normal commercial rate of return on investment of 15% p.a., the investor would need an annual income of about $26M.

Now, assume that the interconnector was able to transmit its full capacity of 220MW from Vic to SA for every hour (8760 hours) of the year. To achieve a return of $26M p.a.; it would require a price differential between Victoria and SA of more than $13/MWh on average for every hour of the year. If one then assumes an average pool price of $30/MWh in Victoria, the SA average pool price would need to be $43/MWh for this investment to be commercially viable. NEMMCO's calculation of average annual prices shows that the differential between Victoria and SA is only a fraction of this.

Even if the SA average pool price was this high, and the average differential between the SA and Victorian pool prices in the magnitude of $13/MWh, the commercial viability of such an investment would be questionable, as the differential is sufficiently high for a new merchant generating plant to enter the SA market and therefore result in a significant reduction in the average pool price in SA.

The fact that an investor may have misread the market or misjudged a commercial opportunity is not an indication of market design deficiencies and the "safe-harbour" provisions were not intended to give MNSP's this protection (particularly given that no other investor in the competitive section of the market gets this protection). They were not designed to favour investors in MNSP's over other non-regulated investors (such as those investing in generation) from poor investment decisions. This issue is addressed further in the attached NERA Report.

The Preliminary View has not identified why Murraylink's commercial viability has been affected by market design deficiencies that have become apparent since Murraylink made its investment decision. Nor has it identified changes to the Market regulatory framework since Murraylink made its investment decision which have materially affected its commercial viability.

B Deficiencies in Methodology and Technical Analysis

TransGrid also has some specific concerns with the methodology and the analyses supporting the conclusions in the Preliminary View. These are:

- The full costs and benefits of Murraylink and all practicable alternatives need to be considered;
- A proper and robust determination of the capacity of Murraylink over the entire project life must be undertaken;
- A recognition of the different functions of the additional capital works proposed by Murraylink to support its interconnector and the works comprising Unbundled SNI;
- That, as currently designed, not all of the proposed alternatives to Murraylink are technically feasible;
- The estimated losses for Murraylink used in benefits calculations are too low; and
- It is not clear what assumptions have been made about dispatch of Murraylink in the NEM in calculating the benefits of Murraylink.

Full costs and benefits of alternatives to be considered

It is evident that additional work needs to be done to fully define Murraylink's capacity over its expected life and to fully define the benefits and costs of all alternatives. It is only then that a proper decision can be made on whether conversion of Murraylink from a MNSP to a TNSP is justified and at what regulated asset base. This issue is discussed in more detail in NERA's Report.

Capacity of Murraylink

VENCorp & PB studies

VENCorp & PB studies appear to be limited to 2003/04 only. There is no mention of what works are required to maintain the 220MW maximum transfer capability for ensuing years. As can be seen from the VENCorp studies, the amount of works required to prop up Murraylink will depend on loads, especially in northwest Victoria. As load grows an ever-increasing amount of work will be required to prop up Murraylink. There is likely to be a technical limit of how much Murraylink can be propped up by similar schemes and in TransGrid's view the best longer-term solution is something similar to SNI upstream works.

Ongoing costs of Murraylink support or cost of SNI upstream works

It appears that the evaluation of Murraylink benefits assumes 220MW capacity is available throughout the project life and that this can be achieved with a one-off set of works worth $8.97M. As has been demonstrated above, this is not correct. The total cost over the project life of maintaining 220MW capability should be included in the project cost. As the problems with capacity limitations are in the upstream side of Murraylink the same capacity limitations will apply to the chosen alternative projects. Similar cost will be required for alternative projects.

If these costs are not included, the benefits accruing from this increase capacity should not be included in the evaluation.

Capability Vs effective transfer

Murraylink may have a maximum transfer capability of 220MW under certain conditions. However, under other conditions the effective amount it can transfer is much reduced. The effective transfer capability is heavily dependent on works to support Murraylink and system conditions and hence the ACCC must be assured that 220MW is the appropriate capacity for its analysis. This issue is discussed in more depth in NERA's report.

SNI upstream works vs. proposed works to support Murraylink

The Preliminary View states that the transfer capability provided by the additional works suggested by MTC and VENCorp will be consistent with the transfer capabilities that Murraylink could achieve if Unbundled SNI were in place. This assessment has not been technically reviewed either by the affected TNSPs or by the IRPC/IOWG.

However, as detailed above TransGrid believes that the works included in the Unbundled SNI or SNI upstream works may be significantly different to those proposed by MTC or those actually required to support Murraylink's capacity during relevant system conditions and over the entire project life.

Murraylink and SNI in parallel

The Preliminary View states that SNI running in parallel with Murraylink will not deliver more capacity than either one operating in isolation. In fact, Murraylink provides a maximum capacity from Vic to SA of 220MW, but only limited capacity from NSW/Snowy to the combined Vic/SA region. SNI provides 250MW capacity into both SA and the combined Vic/SA region.

While the parallel configuration will provide no additional capacity than SNI operating on its own, it will provide some capacity above Murraylink operating on its own. That is, SNI still provides benefits to the market even though Murraylink is in service as a TNSP.

Murraylink Gross Benefits

The Preliminary View quotes gross benefits for Murraylink in the range from $136M to $300M with an median value around $190. These figures appear to be based on data contained in Tables 2.3 and 2.4 supplied by MTC. However, the analysis in the Preliminary View appears to have discounted several benefits. For example:

Riverland deferral	$10-$15M
Controllability	$20-$25M

However, it appears that these figures have not been deducted from the gross benefits calculated by MTC. If the two above alone were included in the calculation, the gross benefits would reduce to $96-$106 at the bottom end of the range. For this case there may well be a negative NPV!

If the gross benefits are reduced significantly and/or the cost of alternatives increases significantly, it may become questionable as to whether Murraylink does in fact have a positive net market benefit.

The analysis needs to be more specific about how a determination on whether the regulatory test has been passed if under some sensitivities or market development scenarios there is a negative NPV.

Controllability

It appears that the controllability has been discounted from some alternatives as not being required. While it is true that controllability is neither essential nor required under the Code for a.c. systems and is a by-product of the dc technology, the capabilities of the selected alternative ac projects is severely limited if no controllability is included, alternatives 1 and 3 are unlikely to work technically without some form of controllability and/or upstream works. Either the benefits of these alternative projects should be reduced or the cost of controllability and/or upstream works should be included.

The technical capabilities of these alternatives need further study. These studies should be carried out by the IOWG.

Technical viability of Alternative 1

Alternative 1 on its own is unlikely to be technically viable. Limitations in the upstream and downstream system are likely to require something similar to the Monash – Robertstown and the upstream works portions of SNI to make the alternative technically viable. Alternative 1 on its own is clearly not similar to SNI.

SNI, including Buronga – Monash, Monash – Robertstown and the upstream works has been estimated to cost about $110M. It is inconceivable that Alternative 1, which incorporates only a small portion of the total SNI project, could cost double the cost of SNI.

Losses

Murraylink estimated losses too low

TransEnergieUS paper titled "Treatment of Murraylink Losses in the Calculation of Market Benefits and A Comparison to Estimated losses for AC Alternative 3" (April 2003) has details of Murraylink actual measured losses (Figure 1) and a formula that gives the estimated Murraylink loss equation used in the market modelling. The output of this equation is supposedly shown on Figure 1 as a comparison to Murraylink actual losses. However, the line on Figure 1 showing the estimated losses does not represent the equation. Figure A below reproduces Murraylink's actual measured losses and correctly shows the loss equation used in the market benefits modelling.

As can be seen from Figure A, Murraylink's actual losses are significantly higher than the losses assumed in the Market benefit calculations. Therefore, the calculated market benefits for Murraylink will be too high.

TransEnergieUS made an estimate of the losses in Alternative 3. Figure A below shows the estimated losses on the Buronga – Monash portion of SNI. It can also be seen that SNI has significantly lower losses than Murraylink across the whole range of power transfer capability. When Murraylink was operating as a MNSP, losses were part of Murraylink's operating costs. If Murraylink becomes a TNSP, these additional losses will eventually be paid for by consumers in the NEM.

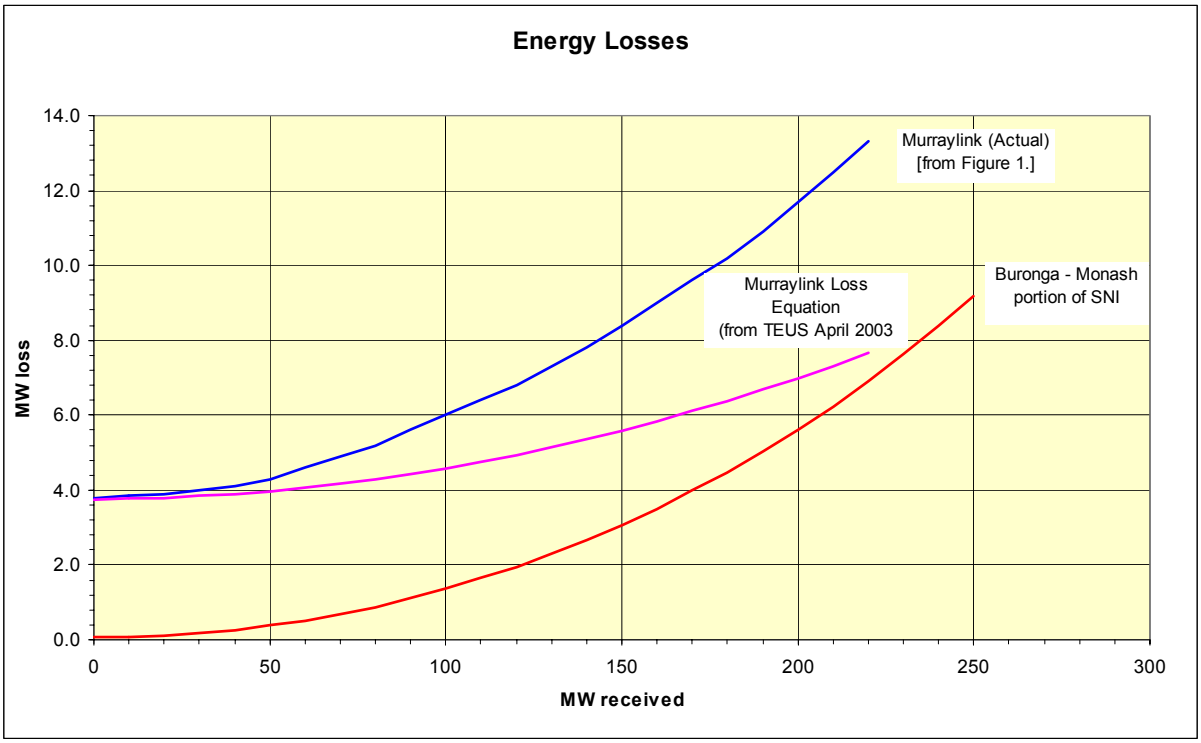

Figure A – Murraylink Losses

Murraylink dispatched to optimise losses

Because the power flow over Murraylink can be controlled, it is possible to vary the power flow sharing of Murraylink and Heywood for a given total interconnector power flow whenever both are not constrained. The power flow sharing will be determined by NEM dispatch. At this time it is unknown how NEM dispatch will handle Murraylink and Heywood interconnectors in parallel.

One possible mechanism is for dispatch to minimise the system losses. These losses will not only be in the Murraylink and Heywood interconnectors but in the networks on either end of them. Under "normal" conditions, increased power flow on Murraylink will incur increased losses on Murraylink itself and in the northwest Vic and southwest NSW 220kV systems. However, losses in the 132kV system from Monash to Robertstown will initially reduce as the Murraylink power flow into Monash will reduce the power flow on this system. Once the power flow on Murraylink into Monash exceeds the Monash load the power flow on Monash to Robertstown will be in the reverse direction and losses on this

system will start to increase again. Similar effects may occur on the Heywood interconnector. Losses will vary with different load and generation patterns. Complex power system analysis is required to find the optimised power sharing that minimises losses.

Murraylink has a fixed loss component of about 4MW. That is, whenever Murraylink is "turned on" there is about 4MW of losses without any net power flow. These fixed losses need to be taken into account when deciding whether to turn Murraylink "on" or "off". These additional losses would need to be offset by an equivalent or greater drop in losses in the Heywood system if total losses were to be minimised.

Figure B below shows the optimum flow on Murraylink that would minimise system losses for a given total interchange to SA for a given set of system conditions. The system conditions assumed for this study approximate peak summer load in SA and Vic with 1900MW import from NSW/ Snowy as well as 70% peak loads with 1000MW import from NSW/Snowy. Sensitivity checks were also done for Monash load at 50% and NW Vic load at 50%.

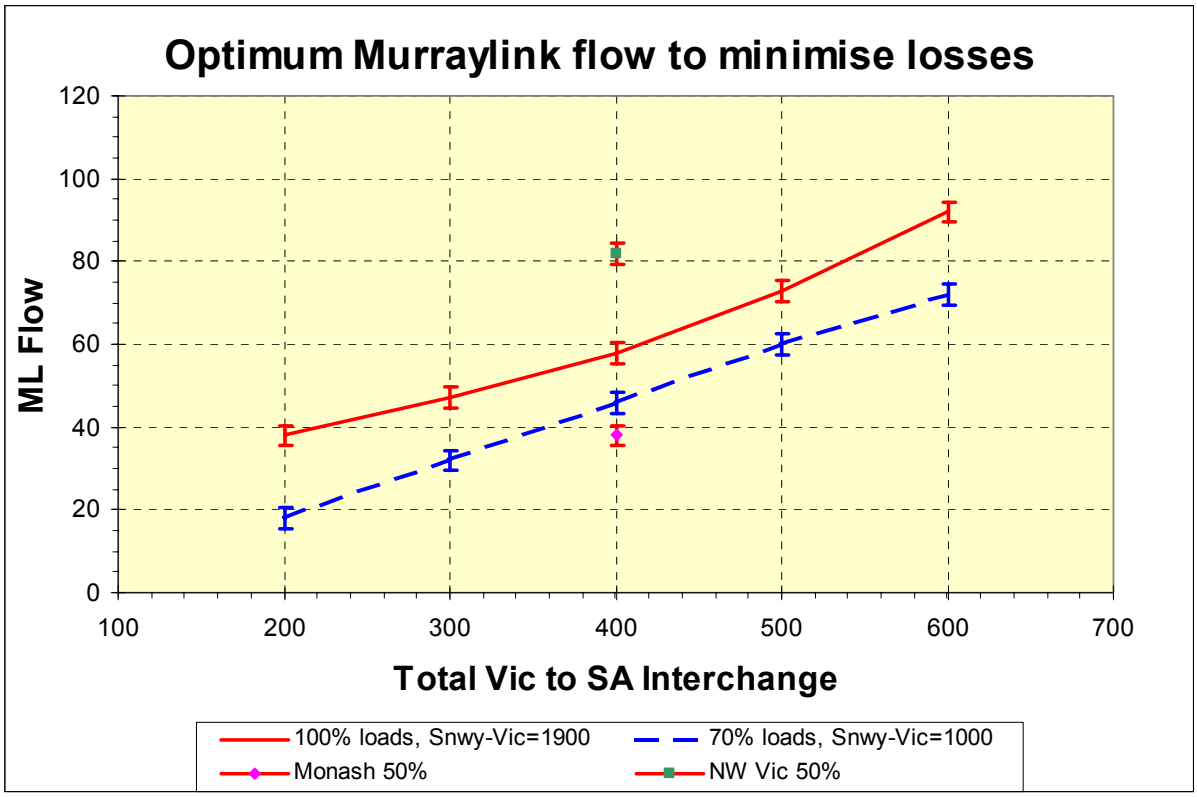

Figure B – Murraylink flow for optimised losses

Figure B shows that while the optimum flow is sensitive to system conditions, the maximum flow on Murraylink is not likely to exceed 100 MW and more often than not will be much lower than this.

While it is accepted that once the Heywood interconnector reaches its limit, Murraylink can continue transferring additional power to SA, under normal circumstances (no constraints) Murraylink will carry very little power to SA. Calculation of Murraylink benefits needs to reflect this reduced effective capacity of Murraylink during normal times.

C IOWG to carry out technical analysis

- It can be seen from above that there are serious deficiencies in the technical analysis associated with MTC application. A sound knowledge of the of the NEM power system is necessary to effectively carry out the required technical analysis of Murraylink's application for conversion. TransGrid is concerned that it is extremely difficult to find external consultants who have this requisite degree of knowledge. The current consultants who have been used to carry out technical analysis may not have the required knowledge of the NEM power system to carry out effective evaluation. The IOWG exists in the NEM for exactly this purpose and is the appropriate body to carry out this analysis. TransGrid submits that any application for

conversion under clause 2.5.2(c) of the Code should be referred to the IOWG, including Murraylink's current application.

D Regulatory Consistency

It is self evident that regulation must be transparent and must be applied equitably and consistently across all regulated entities. In order to ensure regulatory consistency, and a level playing field for all regulated transmission investments in the NEM, the approach adopted by the ACCC in the Preliminary View to issues such as the calculation of WACC, asset valuation methodology, cost pass through and length of regulatory period, must also apply equally to the existing Transmission Network Service Providers. Market participants justifiably expect regulatory consistency and that the regulation will not favour one section of the market over another.

Attachment

"Comments on the ACCC's Preliminary View in Relation to Murraylink's Application for Regulated Status"; NERA, July 2003

COMMENTS ON THE ACCC'S PRELIMINARY VIEW IN RELATION TO MURRAYLINK'S APPLICATION FOR REGULATED STATUS

A Report for TransGrid

Prepared by NERA

July 2003
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1. INTRODUCTION

The Australian Competition and Consumer Commission (ACCC) has released its Preliminary View on the Murraylink Transmission Company Application for Conversion and Maximum Allowed Revenue ('Preliminary View').

The ACCC determination on Murraylink's Application will be the first under the 'safe harbour' provisions in clause 2.5.2(c) of the National Electricity Code. The approach taken by the ACCC in determining Murraylink's Application for conversion and in deriving its allowed revenue will therefore provide an important precedent for any future conversion applications. As such, the approach taken by the ACCC has the potential to impact future transmission investment in the National Electricity Market.

TransGrid has asked NERA to review and comment on the ACCC's Preliminary View. In particular, we have been asked to consider the implications of the ACCC's proposed criteria for conversion for the efficiency of future transmission investment and the appropriateness of the ACCC's proposed approach to deriving the initial regulatory asset value for Market Network Service Providers (MNSPs) that convert to regulated status.

The remainder of this report is structured as follows:

- Section 2 considers the ACCC's proposed criteria for conversion and its implications for the efficiency of future transmission investment;
- Section 3 discusses the ACCC's proposed framework for deriving the initial regulatory asset value for an MNSP that converts to regulated status;
- Section 4 explains the reasons why it is necessary also to consider the gross benefits of alternative projects in deriving the initial regulatory asset value ; and
- Section 5 provides additional comments on some of the specific assumptions adopted by the ACCC in deriving the initial regulatory asset value for Murraylink.

2. BASIS FOR CONVERSION

This section considers the criteria which the ACCC has proposed to use as the basis for exercising its discretion in relation to whether an MNSP should be allowed to convert to regulated status. Specifically, we consider whether the ACCC's proposed approach is consistent with encouraging ***efficient*** transmission investment in the National Electricity Market ('the NEM').

The final part of this section considers the arguments put forward in the Allen Consulting Group report[1] (submitted on behalf of Murraylink) that there have been 'unfavourable regulatory developments' since Murraylink's decision to invest, which justify Murraylink's conversion under the 'safe harbour' provisions of the National Electricity Code ('the Code').

2.1 The Basis for Conversion Proposed by the ACCC

The 'safe harbour' provisions under clause 2.5.2(c) of the Code allow MNSPs to apply to the ACCC for conversion to regulated status.

The ACCC has discretion in deciding how to treat an application for conversion by an MNSP. The ACCC notes in its Preliminary View that it has decided not to apply the regulatory test in exercising its discretion on whether or not to allow conversion.[2] The ACCC has instead decided that the key condition which must be met for an MNSP to convert is that it provides a 'prescribed service', as defined by the Code.[3]

The ACCC cites as justification for its approach that 'the intention of the NECA Working Group was to provide a right for an MNSP to apply for conversion to ensure that investment is not inefficiently inhibited'.[4]

However, the ACCC overlooks a key qualification made by the NECA Working Group. The entire quote from the NECA Working Group (also reproduced in the ACCC's Preliminary View) is that:

> 'Providing a right to apply for regulated status may help ensure that investment is not inefficiently inhibited ***by such non-commercial market design risks***.'[5] (emphasis added)

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1 Allen Consulting Group, ***Application for Conversion of Murraylink to a Prescribed Service - Commentary on the Economic Issues***, April 2003.

2 ACCC Preliminary View, p.14.

3 ACCC Preliminary View, p.14. Note that the flowchart depicting the conversion process provided on p. iii of the ACCC's Preliminary View also requires that the MNSP delivers net market benefits before a conversion determination comes into effect. This is discussed further in section 3.5 of this report.

4 ACCC Preliminary View, p. iv.

The NECA Working Group clearly distinguished between the inhibition of investment as a result of changes in the market design and the 'normal commercial risks' which the MNSP investment would be subject to, such as the risk of having over-judged the future demand for the interconnection service.[6] The ACCC does not address in its Preliminary View the issue of whether there have been changes in market design since Murraylink made its decision to invest.

The ACCC criteria for conversion therefore appears to set what is arguably a ***lower*** threshold for conversion that that implied by the NECA Working Group. In effect, the ACCC's criteria allows an MNSP to convert at will (provided that it offers a prescribed service), rather than linking conversion to external developments.

The ACCC states in its Preliminary View that:

> 'the conversion option enables MNSPs to reduce the risks of their investment by applying for the determination of regulated revenue. By reducing the risks of investment faced by MNSPs, conversion encourages transmission investment in the NEM.'[7]

The ACCC therefore appears to have based its decision on the conversion criteria on the fact that it will encourage transmission investment in the NEM. However, the ACCC does not consider whether the additional transmission investment so encouraged is likely to be ***efficient.***

2.2 ACCC Criteria Will Not Encourage ***Efficient*** Transmission Investment

It is likely that providing a general option for MNSPs to convert to regulated status will result in ***sub-optimal*** future transmission development in the NEM.

The ACCC notes that the option to convert reduces the risk of investment by MNSPs. This is because it provides a limit to the downside-risk which such investment faces. As a result, additional investment in MNSPs may be encouraged which subsequently turns out to reflect a bad commercial decision. The process adopted for determining the regulated asset value which such investment receives on converting may ensure that customers do not end up paying for the cost of the inefficient part of the investment. However, such investment still entails a real resource cost and those resources are not then available for other, more efficient, purposes.

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[5] NECA Working Group on Inter-regional Hedges and Entrepreneurial Interconnectors, ***Entrepreneurial Interconnectors: Safe Harbour Provisions***, November 1998, p.9.

[6] ibid.

[7] ACCC Preliminary View, p. iv and p.15.

Providing an option for an MNSP to convert at will may also mean that efficient ***regulated*** transmission investment will be deterred.

Consider a situation in which there is an existing MNSP that withholds capacity from the market in order to maximise price differentials between two regions and increase the revenue it can earn.[8] In such a situation, it is possible that the addition of a regulated transmission link which reduced this price differential would have a net market benefit.

If the existing MNSP were to convert to regulated status, this would remove the opportunity for the regulated investment, since the price differential the MNSP was previously maintaining would disappear on conversion.

In this situation, if the MNSP is able to convert to regulated status at will, potential proponents of the regulated investment would be unlikely to be prepared to incur the costs of going through the regulatory process to gain approval for the investment. This is because they would anticipate that, once the regulated investment was approved, the MNSP would choose to convert, thereby removing the market benefit associated with the regulated investment and therefore the basis for that investment.

However, ***without*** the threat of regulated investment, the MNSP would have no incentive to modify its behaviour in order to reduce any price differential it is able to maintain between regions. This in turn means that there would continue to be a potential opportunity for a regulated investment which would have a positive net market benefit.

The above scenario raises fundamental questions regarding the rationale for allowing MNSP investments, where market benefit is maximised by open-access transmission investment. These issues are beyond the scope of this report. However, the scenario does illustrate that allowing MNSPs the option of converting to regulated status at will has the potential to result in opportunities for regulated transmission investment which would have a net market benefit not being pursued.

2.3 Market Design Risks

As noted above, the ACCC does not address in its Preliminary View the issue of whether there have been changes in market design since Murraylink made its decision to invest, which have affected the risk Murraylink faces.

Murraylink has submitted a report by the Allen Consulting Group which considers the issue of whether there have been 'unfavourable regulatory developments' which have affected the

[8] We note that the potential incentive for an MNSP to withhold capacity is mentioned in the Allen Consulting Group Report (p.4) and also in the ACCC Preliminary View (p. 22).

ability of Murraylink to capture the benefits it creates.[9]

The examples cited in the Allen Consulting Group report of 'unfavourable developments' are:

- the application of the regulatory test, 'which remains subject to substantial uncertainty'; and
- the absence of ***changes*** to the market rules which may have been expected by Murraylink – namely an increase in VOLL to $20,000/MWh, the introduction of nodal pricing, and changes to the NEM's 5 minute pricing/30 minute settlement arrangement.

In relation to the first of these points, it is important to distinguish between, on the one hand, the ***application*** of the regulatory test and, on the other, the ***rule*** which requires the regulatory test to be applied and the ***form*** of the regulatory test.

Uncertainty exists in relation to any new rule. Successive applications of the rule over time reduce that uncertainty, as a standard approach emerges. However, such uncertainty would typically be considered to be part of the normal 'commercial risk' which a business faces and is not a 'market design' risk. There has been no change to the ***rule*** for the regulatory test to be applied to new transmission investment. The ***form*** of the regulatory test has also remained the same since December 1999.

The second argument in the Allen Consulting Group report is that clause 2.5.2 in the Code was intended to be used if changes were ***not*** made to the market rules where such changes may have been expected by the MNSP.

This line of argument seems clearly in contradiction with the statement made by the NECA Working Group, which referred to: 'additional risks related to market design deficiencies which only become apparent once the first interconnectors are operational'.[10]

This statement appears to clearly refer to ***future*** changes to the ***current*** rules, rather than the ***absence*** of market rule changes assumed by an MNSP. Examples of such changes to the current rules which could affect an MNSP's ability to capture the benefit it provides would be changes to regional boundaries (for example, as the result of the introduction of nodal pricing). The Allen Consulting Group report provides no examples of these type of changes to the market rules having taken place.

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[9] Allen Consulting Group, ***Application for Conversion of Murraylink to a Prescribed Service - Commentary on the Economic Issues***, April 2003, p.7-9.

[10] NECA Working Group on Inter-regional Hedges and Entrepreneurial Interconnectors, ***Entrepreneurial Interconnectors: Safe Harbour Provisions***, November 1998, p.9.

3. DERIVING AN INITIAL REGULATORY ASSET VALUE

This section considers the framework proposed by the ACCC for calculating the initial regulatory asset value (RAV) for an MNSP which converts to regulated status.

Specifically we consider the overall approach set out by the ACCC and contrast this with the approach proposed by Murraylink.

The ACCC's approach to deriving the RAV focuses on the costs of alternative projects to the MNSP. NERA's previous report in relation to Murraylink's Application[11] commented that it is the ***net market benefit*** of each alternative which is important for determining the RAV, rather than solely the ***cost*** of each alternative. We discuss this further in section 4 of this report.

3.1 The ACCC's Proposed Framework

The framework adopted by the ACCC in deriving a RAV for Murraylink appears to be as follows:

(1) the ACCC considers whether Murraylink provides a ***gross*** market benefit, and concludes that it does;

(2) it then considers the cost of alternative projects which provide similar (but not identical) services to Murraylink;

(3) the ACCC has then selected the project with the lowest overall regulatory cost as being the project which satisfies the regulatory test; and

(4) it then sets the RAV for Murraylink on the basis of the capital cost of the lowest cost project, and also sets the opex costs included in Murraylink's regulated revenue projection on the basis of the opex costs of the lowest cost project.

In performing step (3) the ACCC makes the assumption that the gross market benefit of alternative projects will be the similar to that for Murraylink,[12] so that the project with the lowest cost will be the project which maximises the net market benefit.

The ACCC provides a flow-chart of its proposed approach in its Preliminary View. In the flow chart, the ACCC characterises the first step in its approach as being to assess whether the MNSP delivers ***net*** benefits to the market, using the regulatory test.[13] The ACCC goes on in its description of its approach to say that:

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[11] NERA, ***Comments on Murraylink's Application for Conversion to Regulated Status***, January 2003, Section 2.1.

[12] We discuss the implications of this assumption fully in section 4 of this report.

[13] ACCC Preliminary View, flowchart on p.iii. See also discussion on p. ii.

> 'For interconnectors that deliver net benefits to the market, the Commission will set an opening asset value approximating an ODRC valuation'.

The flow chart provided in the ACCC Paper indicates that, where the interconnector does ***not*** deliver net benefits to the market, the application for a revenue cap will be unsuccessful.

The description of the ACCC's approach in the flow-chart does not appear to match the approach outlined in the main body of its report with respect to Murraylink.[14] Our comments in this report are based on the characterisation of the ACCC's approach set out above, rather than on the flowchart provided in the Preliminary View.

3.2 Selection of Alternative Projects

The alternative projects considered by Murraylink in its Application were all designed to provide an equivalent level of service to Murraylink.

The ACCC notes in its Preliminary View that:

> 'for an assessment of an existing interconnector under the regulatory test for the purposes of a conversion application the Commission does not believe it is appropriate for alternative projects to have the exact same level of technical service'.[15]

We concur with this view. The regulatory test analysis will only give an equivalent asset valuation to a DORC analysis if the alternative projects considered are those which provide a ***similar*** level of service, rather than restricting alternatives to providing an ***equivalent*** level of service.[16]

3.3 Contrast with Murraylink's Proposed Approach

The approach proposed by Murraylink was that the maximum regulated cost for Murraylink (RAV plus lifecycle opex) should be determined as the ***minimum*** of:

(1) the gross market benefit of Murraylink;

(2) the cost of an alternative project; or

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[14] We note that if the ACCC calculated the net market benefit for Murraylink on the basis of Murraylink's actual cost, then this would imply a negative net market benefit.

[15] ACCC Preliminary View, p.55.

[16] The Allen Consulting Group report (submitted on behalf of Murraylink) incorrectly claims that optimisation carried out under a DORC valuation does not commonly consider different service potentials (see p. 15 of that report). DORC valuations ***do*** consider similar rather than equivalent levels of service. Specifically, a DORC valuation would consider alternative transmission technologies, to ensure that the choice of technology adopted was appropriate (and was not 'gold-plating').

(3) the cost of Murraylink.

The report by Saha Energy (on behalf of the ACCC) and the later submission by the Allen Consulting Group (on behalf of Murraylink) both characterised this approach as equivalent to an ODV approach to asset valuation.

In Murraylink's Application, the gross market benefit of Murraylink was calculated as being ***below*** the cost of alternative projects. As a result, Murraylink determined its RAV on the basis of its gross market benefit (which it claimed to be equivalent to its 'economic value').

The ACCC has made adjustments to the alternative projects considered by Murraylink, to reflect its view that the service provided by alternative projects need not be equivalent to Murraylink. Specifically, the ACCC has removed elements associated with undergrounding and controllability. These adjustments reduce the cost of the alternative projects and mean that the cost of Alternative 3 is now ***below*** the gross market benefit of Murraylink.

On the basis of the revised costs of the alternatives, Murraylink's proposed approach would also imply that it is the cost of alternative 3 which is relevant for determining the RAV of Murraylink. The only difference between the ACCC and Murraylink approaches in this instance is the approach taken to determining the split of the total regulatory cost between the initial RAV and the opex allowance. We discuss the differences in the approach in section 3.4 below.

The key difference between Murraylink's approach and that adopted by the ACCC is therefore how the RAV is to be determined if the cost of alternative projects is greater than the gross market benefit of the MNSP. We consider this point further in 3.5 below.

3.4 Derivation of the Operating Cost Component of the MNSPs' Revenue Requirement

The ACCC proposes to set the RAV for an MNSP on the basis of the capital cost of the lowest cost alternative and to set the operating cost component of the revenue requirement on the basis of the operating costs of the lowest cost alternative. In relation to Murraylink, this approach means that the ACCC has determined Murraylink's allowed opex on the basis of the opex estimated for Alternative 3.

The approach proposed by the ACCC is unlikely to be robust going forward. Deliberately setting an operating cost allowance which is below the actual operating costs associated with the MNSP may lead to pressure for the regulatory arrangements to be reopened during the regulatory period. It would also raise difficulties in deciding on what basis operating expenditure should be set in ***future*** regulatory periods.

A more preferable approach would be that proposed by Murraylink. In order for the total regulated cost of the MNSP to equal the total regulated cost of the alternative which satisfies

the regulatory test, the actual expected lifecycle operating costs associated with the MNSP should be subtracted from the total regulatory cost of the alternative in order to derive the RAV for the MNSP. The MNSP's actual projected operating cost should then be included in determining the revenue requirement.

This approach will result in the same overall regulated cost for the MNSP as under the approach proposed by the ACCC. However, it is likely to be more robust in that the operating cost allowance reflects the actual expected operating cost for the MNSP, and at the time of the next regulatory review actual outturn operating expenditure can be used as a basis for determining the operating cost projections going forward.

In relation to Murraylink, this approach would imply that Murraylink's projected opex be subtracted from the total regulated cost of Alternative 3, in order to derive Murraylink's RAV. Murraylink's projected opex should then be included directly in determining its revenue requirement. Such an approach will result in a RAV for Murraylink which is ***below*** the capital cost of Alternative 3,[17] but overall the total regulatory cost of Murraylink and Alternative 3 will be equal.

If the revenue requirement for Murraylink is set on the basis of its actual opex projections, then the ACCC would need to review those projections in order to ensure that they are realistic and adequately reflect the extent of operating cost efficiencies which may be achieved over the regulatory period. This is particularly important given the longer regulatory period for Murraylink determined by the ACCC. We note the comments provided to the ACCC by PB Associates on aspects of Murraylink's projections which appear conservative.[18]

3.5 ACCC's Approach When the Cost of Alternatives is Above the Gross Market Benefit

The ACCC's conclusion in its Preliminary View is that it intends to determine the RAV for MNSPs on the basis of the lowest cost alternative, 'which is akin to a DORC methodology'.

The discussion in the ACCC's Preliminary View focuses on situations where the net cost of alternative projects implies a positive net market benefit. That is, the cost of the alternative projects considered is below the gross market benefit. Specifically, in deriving the RAV for Murraylink, the revisions the ACCC has made to the costs of the alternative projects mean that the lowest cost of Alternative 3 is now below the gross market benefit of Murraylink.

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[17] Murraylink previously estimated its lifecycle opex at $37.3m (see Murraylink Application), although the ACCC Preliminary View notes that this figure has since been revised. The estimate of the opex cost for Alternative 3 in the ACCC's Preliminary View is $16.95m (p.59).

[18] ACCC Preliminary View, p. 84.

It is not absolutely clear from the ACCC's Preliminary View what RAV would be applied if the cost of alternative projects were ***above*** the gross market benefit of the MNSP. In order for the framework for future conversion to be robust, it is important that the intended approach in this circumstance is also clearly set out.

Murraylink proposed in its Application that, in this case, the regulated cost for the MNSP should be based on its gross market benefit, which it submitted is a proxy for economic value. This approach was characterised as being consistent with the ODV approach to asset valuation.

The ACCC Preliminary View includes a discussion of whether the market benefit derived from the regulatory test is a suitable proxy for economic value.[19] The ACCC comments that determining economic values can be problematic, given the dependence of the economic value on the regulatory framework. It also notes that it is not convinced that defining the economic benefit of an MNSP as equal to its gross market benefit is appropriate. It expresses concern that it is difficult to provide a single estimated value under this approach, as the gross market benefit is subject to variability, depending on the particular assumptions and values used in the regulatory test. The ACCC contrasts the economic value approach with the ODRC approach, which it says is well-defined. As a result, the ACCC rejects the economic value approach.

However, in rejecting the ODV approach put forward by Murraylink, the ACCC has not made clear what approach it would take in deriving the RAV for an MNSP in the event that the cost of the alternative projects was greater than the gross market benefit.

Where the cost of alternatives exceed their benefits, setting the RAV for the MNSP at the lowest cost of an alternative would result in the MNSP having a ***negative*** net market benefit. A possible interpretation of the ACCC's approach is that in this case the MNSP would not be eligible for a revenue cap determination.[20]

However, it is difficult to see the basis for the ACCC rejecting conversion in this circumstance. Provided that the regulatory cost of the converting MNSP is set at or below the gross market benefit of the MNSP, there would still be a net market benefit from allowing the MNSP to convert. The pragmatic difficulties cited by the ACCC with calculating a single value for the gross market benefit do not appear to be sufficient to conclude that conversion should not be allowed to proceed solely on this basis.

In order to provide a clear framework for the future conversion of MNSPs it would be beneficial for the ACCC to set out its approach more clearly in the event that the cost of alternatives exceeds the gross market benefits.

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[19] ACCC Preliminary View, p. 39-40.

[20] This is one possible interpretation of the role of the question 'Does it deliver net market benefits?' in the flowchart shown on page iii of the Preliminary View.

4. GROSS BENEFITS OF ALTERNATIVE PROJECTS NEED TO BE TAKEN INTO ACCOUNT

In NERA's previous report commenting on Murraylink's Application, we highlighted that it is the ***net benefit*** of alternative projects which should be the relevant comparator in deriving an MNSP's RAV for conversion purposes, rather than the ***cost*** of alternative projects, given that the gross market benefit may differ between projects.[21]

Failure to consider the net benefits of alternative projects in determining the RAV means that the outcome of the conversion process may end up being materially different to the outcomes of the regulatory processes under Section 5 of the Code. A material difference may arise because:

- ignoring differences in market benefits may limit the alternative projects considered;
- ignoring differences in market benefits may affect the selection of the project which has the greatest 'net market benefit'; and
- where the gross market benefit of alternative projects differ, focusing only on the costs of alternative projects means that the approach does not result in the same RAV that would have applied if the processes under Section 5 of the Code had been followed.

In this section we expand on the above points.

4.1 ACCC Approach will Only be Consistent with the Provisions in Chapter 5 of the Code if Gross Benefits are the Same

The ACCC maintains that its approach to deriving the RAV will ensure that an MNSP will not accrue a material advantage through bypassing the relevant provisions in chapter 5 of the Code.[22] These provisions are essentially the requirement for regulated transmission investments to pass the regulatory test.

Not accruing a material advantage from bypassing the provisions of Chapter 5 implies that the valuation process applied to MNSPs converting to regulated status should not result in a ***higher*** asset value than if the network asset had been proposed as a regulated network asset and required to pass the regulatory test.

The ACCC's proposed approach to deriving the RAV will only result in the same valuation as that under the provisions of Chapter 5 if the gross market benefits of alternative options

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[21] NERA, ***Comments on Murraylink's Application for Conversion to Regulated Status***, Section 2.1, p.3-5.

[22] ACCC Preliminary View, p. ii.

are the same. Where the gross market benefits of the alternatives differ, the RAV which results from the ACCC's approach may end up being higher or lower than that which the transmission business would have received if it had applied for regulated status initially, rather than converting.

Ignoring potential differences in the gross benefits of alternative projects therefore means that the ACCC's approach will not result in the same outcome as would have occurred under the provisions of chapter 5 of the Code.

4.2 ACCC Approach Assumes Gross Benefits of Alternative Options are Equal

It is unclear from the ACCC's Preliminary View whether or not the ACCC considers that the gross market benefit of alternative options should also be considered, together with the costs of alternative options.

The ACCC says that:

> 'While the Commission is of the view that care must be taken not to use the apparent size and benefits provided by the proposed augmentation as the basis for comparing it to alternative augmentations, and that the gross market benefits of the alternatives are considered.'[23] (sic)

This is presumably to be interpreted as saying that the gross market benefit of alternative projects ***should*** be considered. However, elsewhere in the Preliminary View the ACCC notes that:

> 'the Commission will take into account the cost and configuration of what it considers to be the lowest cost option for a regulated interconnector that provides ***a certain level of gross market benefits***.'[24] (emphasis added)

In practice the ACCC has not considered the different benefits of alternative projects in deriving the RAV for Murraylink.

The ACCC's rationale for not considering gross benefits in the case of Murraylink appears to be a pragmatic judgement that: 'the market benefits of the alternatives are unlikely to significantly differ from the market benefits of Murraylink.'[25]

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[23] ACCC Preliminary View, p.44.

[24] ACCC Preliminary View, p.24.

[25] ACCC Preliminary View, p.44.

However, this judgement is not supported by the ACCC's own assessment that: 'a reconfiguration in the alternatives [to Murraylink] could possibly reduce their market benefits'. [26]

Indeed, in reconfiguring the alternatives, the ACCC has removed the phase shifting transformers from Alternative 3 and the phase shifting regulators from Alternative 1, which it notes may be expected to reduce the gross market benefit of those options by around $20-$25m.[27] It is therefore clear that the gross market benefit of each of the alternatives to Murraylink will not be the same as the gross market benefit of Murraylink.

4.3 Impact on Choice of Alternative Projects Considered

Failure to consider the gross market benefit associated with alternative projects may impact on the choice of alternatives used in the assessment to determine the RAV.

The ACCC comments that it has not further expanded the range of alternative projects considered in the assessment of Murraylink. It notes that the costs of other alternatives proposed were generally higher than the adjusted costs of the BRW alternatives.[28]

In terms of considering further alternatives, we note that it is not the ***costs*** of alternative projects which is relevant, but the ***net benefit***. Alternative projects which have a higher cost may also result in a proportionally greater benefit.

We note that the ACCC has not considered alternative timings for Murraylink as potential alternative projects. The net market benefit may differ depending on the timing of the investment. By assuming that the gross market benefit is fixed, the ACCC potentially ignores such alternative projects.

As a result, the alternative projects against which Murraylink has been considered in determining the RAV may be less varied than those against which it would have been assessed had it been constructed as a regulated interconnector and required to pass the regulatory test. This could potentially have a material impact on the RAV derived.

4.4 Impact on Ranking of Alternative Projects

The ACCC's conclusion in its Preliminary View is that it intends to determine the RAV for MNSPs on the basis of the lowest cost alternative.

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[26] ACCC Preliminary View, p.44.

[27] ACCC Preliminary View, p.47. The ACCC states incorrectly that the gross market benefit of Murraylink would be reduced by the same amount; the comment by BRW applies only to the AC alternatives.

[28] ACCC Preliminary View, p. 55.

In order to be consistent with the provisions in Chapter 5, the ACCC would need to base the valuation on the cost of the option which has the greatest net market benefit. Where the gross benefit of different options vary, this need not be equivalent to the option with the lowest cost.

4.5 Impact on Derived RAV

If the MNSP's RAV is determined on the basis of the cost of the project with the highest net market benefit, this does not imply that the RAV will be the same as that which would have resulted if the project had been required to pass the regulatory test under the provisions of chapter 5.

This is illustrated in the examples below.

Consider an MNSP with an actual cost of $100m and a gross market benefit of $110m. Alternative X has a cost of $80m and also has a gross market benefit of $110m. Alternative X is therefore the option with the highest net market benefit.

Under the ACCC's approach, the regulatory cost of the MNSP would be set, not at its actual cost, but at that of the lowest cost alternative (ie, Alternative X). The derived regulatory cost for the MNSP is therefore $80m (shown in the shaded cell in table 4.1). This is also the cost which the MNSP would have needed to have in order to pass the regulatory test, if it had applied to be constructed as a regulated interconnector initially. As a result, the outcome of the conversion process is consistent with that which would have occurred under the regulatory test, and no advantage accrues to the MNSP from bypassing these provisions.[29]

Table 4.1
Derived Regulatory Cost Equals Cost at which MNSP Passes Regulatory Test if Gross Benefits of Alternatives are Equal

	Regulatory Cost ($m)	Gross Benefit ($m)	Net Benefit ($m)
MNSP (actual cost)	100	110	10
Alternative X	80	110	30
MNSP (derived cost)	80	110	30

However, if the gross market benefit of Alternative X is not equal to that of the MNSP, the outcome of the ACCC's approach will no longer be equivalent to that obtained under the regulatory test.

[29] Note that in considering whether an advantage accrues to the MNSP, the relevant comparison is what the MNSP would have received as a regulated cost if it applied as a regulated interconnector versus what it could receive through conversion. In neither case is the interconnector receiving its actual full cost.

Table 4.2 illustrates this for a situation in which the gross market benefit of Alternative X is ***above*** that of the MNSP.

Table 4.2
Derived Regulatory Cost Greater Than Cost at which MNSP Passes Regulatory Test if Gross Benefits of Alternatives are Higher

	Regulatory Cost ($m)	Gross Benefit ($m)	Net Benefit ($m)
MNSP (actual cost)	100	110	10
Alternative X	80	120	40
MNSP (derived cost)	80	110	30

Setting the total regulatory cost for the MNSP at the same level as that implied for Alternative X (ie, $80m) no longer implies that at that cost the MNSP also satisfies the regulatory test. For the MNSP to pass the regulatory test, it would need to have a net market benefit of $40m (ie, to have the same net market benefit as Alternative X), which implies that its cost would need to be $70m. Under the proposed ACCC approach, the MNSP therefore receives a regulatory cost of $80m. In contrast, if it had applied for regulated status initially under the provisions of Chapter 5 of the Code, it would only have been granted regulatory status if its costs were (at or below) $70m. There is therefore a material advantage to the MNSP from bypassing the regulatory test.

The MNSP may also be disadvantaged under the ACCC's approach. Table 4.3 presents the same situation, but where the gross market benefit of Alternative X is ***below*** that of the MNSP.

Table 4.3
Derived Regulatory Cost Less Than Cost at which MNSP Passes Regulatory Test if Gross Benefits of Alternatives are Lower

	Regulatory Cost ($m)	Gross Benefit ($m)	Net Benefit ($m)
MNSP (actual cost)	100	110	10
Alternative X	80	100	20
MNSP (derived cost)	80	110	30

The MNSP still receives a regulated cost of $80m under the ACCC's approach (ie, the cost of Alternative X). However, it would have passed the regulatory test with a cost of $90m.

4.6 Practicality of Deriving a RAV Based on an Assessment of Net Benefits

In order to ensure that an MNSP does not accrue a material advantage (or disadvantage) from bypassing the provisions of Chapter 5 of the Code, the regulatory cost for an MNSP which converts to regulated status would need to be set at:

- the gross market benefit of the MNSP ***minus***
- the highest positive net market benefit associated with an alternative project.

This approach was set out in the earlier NERA report.

The Allen Consulting Group report submitted on behalf of Murraylink noted that the above approach (which it termed the 'service-adjusted DORC approach') was 'arguably theoretically correct'.[30] However, the report argued that the approach is not practical, in that it would be very costly to apply to all valuations and re-valuations, and would not yield robust results.

We note that the approach to calculating the 'service-adjusted DORC' as described in the Allen Consulting Group Report[31] ***exactly mirrors*** the approach which regulated assets are required to go through in order to become eligible for regulated status. That is, the necessary analysis is the same as that required in applying the regulatory test.

As a result, even though the ACCC may not apply this approach in deriving its DORC valuation for regulated assets, it is ***exactly*** the approach which regulated businesses are required to apply in order to become eligible for regulated status in the first place. The DORC valuation applied to these assets by the ACCC does not therefore also have to consider the market benefit from 'all alternative options', since this consideration has already taken place in applying the regulatory test.

In contrast, an MNSP's assets have not undergone this 'prior screening' to determine that they are the optimal investment. In this context, applying the 'service-adjusted DORC' valuation to MNSPs converting to regulated status is simply bringing the valuation approach applied to the MNSP in line with the process applying to regulated assets, and ensuring consistency in treatment between the two types of asset. It is no more administratively burdensome for the MNSP to provide this type of valuation in applying for regulated status than is the application of the regulatory test by TNSPs for regulated assets.

From the ACCC's discussion of DORC value versus economic value it appears that the difficulties associated with obtaining a robust estimate of the gross market benefit would

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[30] Allen Consulting Group, ***Application for Conversion of Murraylink to a Prescribed Service - Commentary on the Economic Issues***, April 2003, p. 14.

[31] Op cit, p. 16.

make the ACCC reluctant to base a valuation on the calculation of the market benefits of alternatives options, as described above.

However, the implication of ***not*** taking this approach is that an MNSP may receive a material advantage from bypassing the provisions in Chapter 5 of the Code. This in turn has implications for the dynamic efficiency of future investment.

5. ADDITIONAL COMMENTS ON THE ACCC'S ANALYSIS

This section provides comments on two specific areas of the ACCC's analysis in deriving the RAV for Murraylink, namely:

- the consistency of the assumptions made regarding Murraylink's transfer capacity and future investment; and
- the methodology used to calculate reliability benefits.

5.1 Murraylink Transfer Capacity

Murraylink's transfer capacity will affect the extent of the gross market benefits it delivers. TransEnergie US' (TEUS) assessment of the gross market benefit assumes that Murraylink has a transfer capacity of 220MW.

The ACCC has concluded that Murraylink currently has a transfer capacity of 180MW, but that it will be able to achieve a transfer capacity of 220MW if additional augmentations are in place. These augmentations are identified as either:[32]

- additional capex totalling $8.97m undertaken by Murraylink in 2004/5 plus additional works proposed by VenCorp; or
- Unbundled SNI.

Murraylink has not committed to undertaking the additional works identified, and is reported as saying that it will make a decision in the light of the ACCC's decision on its RAV. [33] We note that the ACCC has included the additional $8.97m capex amount as part of its calculation of Murraylink's regulated revenue requirement. The amount is shown in nominal terms in calendar year 2006.[34]

In order for the analysis to be robust, there needs to be consistency between:

- the commitment (if any) made by Murraylink to spending the capex required to augment its capacity and the amount included in the capex projections for Murraylink's regulatory revenue; and

[32] ACCC Preliminary View, p. vii.

[33] ACCC Preliminary View, p.46.

[34] We have assumed that the ACCC's reference in Table 3 to 'Financial year ending 30 December' is intended to be a reference to the calendar year.

- the commitment (if any) made by Murraylink or another party to carrying out the necessary works to augment transfer capacity and the transfer capacity assumed in the calculation of the gross market benefit.[35]

Given that Murraylink has not committed to undertaking the additional capex, it is not appropriate to include it in its revenue requirement.

In addition, to the extent that there is no current commitment to carry out the works necessary to augment Murraylink's transfer capacity, the gross market benefit would be more appropriately calculated on the basis of 180MW capability.

5.2 Reliability Benefit

The ACCC notes that TEUS' approach to calculating the reliability benefit associated with Murraylink differs from the approach adopted by the IRPC. TEUS does not explicitly consider the deferral of reliability generation. Instead, TEUS projects the differences in the expected amount of unserved energy between 'with Murraylink' and 'without Murraylink' cases, and values this difference at VOLL.

TEUS has recalculated the reliability benefit on a consistent basis with that adopted in previous applications of the regulatory test, in order to test the materiality of the difference in approach. The gross market benefit calculated for Murraylink falls by $42m under the IRPC approach, ie, from $214m to $172m.[36] This is a reduction in Murraylink's gross market benefit of nearly 20%.

The ACCC in its Preliminary View appears to endorse TEUS' alternative approach to calculating reliability benefits, after July 2005 (when NEMMCO's recently renewed Reserve Trader provisions are currently due to expire). Specifically, the ACCC states that 'it does not find that TEUS assumption adopted to be inappropriate and inconsistent with the code or the regulatory test if such a methodology is adopted beyond 2005.'[37]

It would be desirable for the ACCC to confirm that this methodology for calculating reliability benefits is acceptable, since it is relevant not only for the TEUS application in this instance, but also more generally in all applications of the regulatory test by transmission network service providers. It would be appropriate for the ACCC to also confirm the acceptability of this approach in the outcome of its current review of the regulatory test.

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[35] Currently there also appears to be a timing mismatch in the analysis between when the capex associated with augmenting transfer capacity is included in Murraylink's asset base (2006) and when the benefit calculation assumes that the higher transfer capacity is in place (2004/5).

[36] TEUS, Further Comments on Murraylink Reliability Benefits and Other Modelling Issues, p.4. The reduced gross market benefit of $172m is reported in the ACCC Preliminary View, p.45.

[37] ACCC Preliminary View, p. 44.

We note that TEUS' argument in favour of its alternative approach is that the market can be expected to mature and NEMMCO's 'safety net' role as the Reserve Trader will no longer be required.

A 'maturing of the market' means that sufficient generation investment is expected to result from market forces to ensure that the level of expected unserved energy remains at an acceptable level. The projections of future generation investment included in the analysis therefore need to be consistent with this expectation. Specifically, we would expect that the analysis would reflect a higher amount of market-driven investment than if a continuation of the reserve-trader arrangements were assumed, such that future projected unserved energy remained within acceptable bounds.

The TEUS analysis in fact projects an increase in the future amount of unserved energy, which would put it significantly ***above*** acceptable reliability levels. The approach does not therefore appear to reflect what would happen in practice under a 'mature market'.