Mr Michael Rawstron
General Manager
Regulatory Affairs - Electricity
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Dear Michael

Attention: Mr Theo Gazos

Re: VENCorp's Electricity Revenue Cap Application & PB Associates Review

I refer to the application from VENCorp to the ACCC in relation to its Electricity Revenue Cap Application, and the subsequent comments by PB Associates on this application.

In essence, and having regard for the current Victorian regulatory arrangements, TransGrid supports the annual reset of operating and capital expenditure proposed by VENCorp, where each reset is subject to review by the ACCC. This letter does not comment on the appropriateness of the levels of proposed operating and capital expenditure.

However, it is essential that the ACCC, at least initially, conduct these annual reviews in a detailed, thorough and transparent fashion while the current transmission arrangements prevail in Victoria. This should include reasonable levels of public consultation.

This is needed to ensure that:

- End use customers are not disadvantaged by inefficient practices on the part of VENCorp;
- The competitive arrangements in Victoria are truly effective; and
- Costs and risks that will be passed through to end use customers under the current Victorian arrangements are minimised.

Each of these points is briefly illustrated in turn.

1. Efficiency Drivers on VENCorp

VENCorp is unlike any other TNSP in the NEM in that it operates as a 'not for profit' organisation. This puts VENCorp out of reach of the commercial incentives that apply to other TNSPs. For example the 5 year, CPI-X regime contemplated by Chapter 6 of the NEC cannot be applied to VENCorp's operations. Nor is it possible to apply commercial incentives linked to proposed performance measures (currently under consideration by the ACCC in their TNSP Service Standards Review). This latter point is very important because planning decisions, for which VENCorp is responsible, are a major determinant of transmission reliability, transmission congestion, and other aspects of transmission service provision.

2. Determining that the Victorian Transmission Arrangements are Truly Competitive

The objective of these arrangements is to inject competition into the transmission sector and rely on this competition to drive innovation and efficiency. In addition, if competition is truly effective the need for ACCC oversight would, in theory, be removed. At this stage there are prima facie concerns that competition is sufficiently effective to warrant such faith.

Firstly, the regime is relatively untested. It is unique in that there is no similar regime in operation anywhere in the world. In addition, the scope and scale of projects subjected to this regime has been modest to date. By way of example, the regime is yet to be applied to a major transmission line development where the costs and project risks are typically greatest in transmission augmentation.

Secondly, many elements of the Victorian regime sit outside the contestability framework. For example, planning decisions are carried out in much the same way as with other TNSPs. VENCorp applies the regulatory test and, in so doing, is subjected to the same levels of public and Board scrutiny as other TNSPs. In addition, SPI Powernet's competitive advantage in relation to augmentation of the existing Victorian transmission system is likely to be significant, and this would account for a material proportion of transmission development in Victoria.

Finally, there are indications that competition in relation to greenfield transmission projects may be less than robust. This is indicated by the relatively small number of bidders in some instances as well as the structure of the market in Australia for the provision of transmission plant. It should also be recognised that other TNSPs capture much of this contestability by contracting out for transmission construction and plant provision on a competitive basis. Despite this, these TNSPs are still subjected to regulatory oversight, presumably because the level of competition delivered by this practice is considered inadequate.

Accordingly close regulatory oversight is required for the time-being to protect customers and gain confidence in the veracity of competition under the Victorian regime.

3. Costs and Risks Passed Through to Customers

Under current Victorian arrangements, and without effective and transparent regulatory oversight, a number of costs and risks appear to be passed through to customers. These include:

- higher rates of return of capital (depreciation charges);
- optimisation risk;
- lack of access to cost reductions associated with new technology; and
- greater exposure to network performance risks.

<u>Exposure to Higher Depreciation Charges</u>

The return of capital to the providers of transmission infrastructure is related to the term of the contract. When VENCorp seeks competitive bids for the supply, construction, ownership, operation and maintenance of new transmission infrastructure, it does so on the basis of a fixed term contract. A commercial bidder would be expected to achieve a reasonable return on capital and return of all invested capital over the period of the contract in question. This implies that the term of the contract determines the rate of depreciation of the assets in question. VENCorp's revenue application is seeking to have these actual costs passed through to customers. That is, without close control of the term of these contracts by the ACCC, customers will be paying for higher rates of depreciation than provided for in the ACCC's draft Statement of Regulatory Principles.

Optimisation Risk

The ACCC has made its position quite clear on optimisation risk. In the draft Statement of Regulatory Principles it states:

> "*Where there is a high potential for full or partial stranding to occur it needs to be considered whether an economic value lower than DORC should be set. In such a situation the regulator is unlikely to be as well placed as the TNSP to identify assets at risk of by-pass well in advance of the threat actually materialising."*

Some capacity is offered to TNSPs to manage this risk by allowing for accelerated depreciation where a TNSP can reasonably foresee the prospect of future optimisation risk. However, to the extent that excessive capacity is identified in the transmission system, and this has not been adequately captured by the exercise of this provision, it is the TNSP rather than the customer that carries this risk.

Accordingly, TransGrid agrees with Powerlink's views (VENCorp Submission for the Revenue Cap dated 27 May 2002) that the ACCC should apply 'optimisation risk' equitably to all TNSPs. If, in Victoria, the ACCC agrees to waive the requirements of the draft Statement of Regulatory Principles and pass this risk through to customers, then this advantage should be provided to all TNSPs in the NEM.

New Technology Risk

PB Associates recognises that the current framework applied to future augmentation (as outlined in 6.1, page 32) 'does not necessarily protect VENCorp from the introduction of new technologies when the contract terms are completed'. However, it is clear that, under the proposals in the VENCorp revenue application, there is no scope to apply a revised ODRC valuation of these assets until the completion of the relevant contract. Where such a contract has a period of 20 years or more, customers will not receive the same reduction in charges each five years due to reduced asset replacement costs that they would obtain from other TNSPs. That is, other TNSPs carry risks of revenue reduction due to new technology and other factors that reduce replacement costs, not faced by VENCorp. Again, as suggested by Powerlink, this is inequitable to the other TNSPs. It also disadvantages Victorian customers relative to customers in other jurisdictions.

Greater Exposure to Network Performance Risks

Another emerging risk is the risk associated with network performance. Under the current ACCC TNSP Service Standards Review, TNSPs will be subjected to a Performance Incentive (PI) Scheme. This scheme will now expose TNSPs to additional network performance risks that will have a monetary impact on the revenue stream of a transmission business. Planning and investment decisions have a major impact on network performance over time. With 'for profit' TNSPs that carry out planning the performance incentive regime can be extended to include the 'quality' of planning decisions and the ability to deliver system augmentations in a timely fashion.

As noted above, it is not clear how these performance drivers are to be extended to VENCorp under the proposals set out in the VENCorp revenue reset application. In this regard at least two issues are apparent.

Firstly, VENCorp is a 'not for profit' body resulting in all its functions, including planning decisions and timing of project implementation, lying outside of any performance scheme built around financial incentives.

Secondly, it is not always clear whether poor performance of a transmission system is due to poor planning and augmentation timing, or poor maintenance practices.

For example, existing transmission plant may be subjected to high loads and/or delays in maintenance because of inadequate or delayed network upgrades. If the plant in question subsequently fails, leading to interruption in supply, questions will inevitably arise as to whether the failure was due to the high loads and difficulties getting outages for maintenance work (poor network planning) or poor maintenance practices. This issue does not arise when a single entity has responsibility for both functions.

Taken together these issues make it difficult to place effective service performance incentives on VENCorp and create performance improvements that can be shared with customers over time. Indeed, poor performance by VENCorp would simply be passed through to customers under current arrangements.

At least initially, these concerns require a high level of regulatory oversight. Accordingly, the proposal by VENCorp to have its operating and capital costs reviewed annually by the ACCC is supported, provided that such oversight is thorough, transparent, and provides reasonable levels of public consultation.

Should you have any queries in regard to this submission, please feel free to contact Mr Philip Gall (Manager – Regulatory Affairs) on (02) 9284 3434.

D W Hutt
General Manager/Corporate Development