Submission on the ACCC'S Draft Decision:

Statement of Principles for the Regulation of Electricity Transmission Revenues

1 INTRODUCTION

This document sets out VENCorp's response to the ACCC's *Draft Decision on the Statement of Principles for the Regulation of Electricity Transmission Revenues*, and the accompanying *Background Paper*. VENCorp's response addresses the following five issues which arise in the *Draft Decision*:

- asset base valuation;
- regulatory and incentive arrangements governing capital expenditure;
- regulatory and incentive arrangements governing operating expenditure;
- WACC; and
- service standards.

2 ASSET BASE VALUATION

The proposed approach to asset valuation described in the *Draft Decision* is to lock-in the regulated asset base. This approach differs from that described in the ACCC's earlier draft Statement of Regulatory Principles (May 1999), which supported periodic asset revaluations using a DORC methodology.

VENCorp supports the proposed approach in the *Draft Decision* to lock-in the regulated asset base (RAB).

In VENCorp's view, the regulatory regime should encourage TNSPs to identify the most efficient investment plans, and to execute them in a cost-effective manner. Once an investment is included in the RAB, it seems reasonable for the TNSP to be insulated from subsequent stranding risk. The rationale for this approach is that investment decisions can only be made on the basis of the information available at that time. It does not serve any purpose to reappraise an investment decision using new information, which only became available after the investment decision was made. In essence, the DORC methodology periodically exposed "sunk" investment decisions to on-going stranding risk, without providing any benefit to customers or the TNSP in terms of improving the original investment decision. Importantly, once it is accepted that assets entering the RAB should not be subject to stranding risk, an important regulatory focus must be to ensure that only prudent investments enter the RAB.

3 CAPITAL EXPENDITURE

VENCorp understands that the ACCC's proposed incentive regime for capital expenditure consists of three elements:

- An ex ante cap. This allowance is intended to cover most or all expected investment during the period of a regulatory control, including more discretionary investment not related to statutory reliability obligations.

- Excluded projects. This allows for separate, project-specific regulation for very large and uncertain investments.

- An "off-ramps" mechanism. This mechanism adjusts the capital expenditure allowance if unexpected events impacting capital expenditure requirements arise during the regulatory period.

In relation to the ex ante cap:

- We suggest as a general principle that only load growth related augmentation projects should be included in the ex ante cap. This would appear to be consistent with the principle that uncertain or unexpected augmentations (such as those related to new generators), be handled as an excluded project.

- VENCorp notes that the ex ante cap may change in response to a change in the main investment drivers, such as load growth or peak demand. A question arises as to whether this approach is consistent with the Code requirement that the TNSPs should be revenue capped. Nevertheless, VENCorp has some sympathy with the view that a revenue cap may not be the most appropriate form of control in circumstances where costs change with load or peak demand. The ACCC should be cautious in designing the ex ante cap to ensure that it does not provide inappropriate incentives to encourage increased load growth or discourage demand-side initiatives.

- The *Draft Decision* explains that the ex ante cap does not entail specific project approval, nor does it require particular projects to be undertaken[1]. Instead, the cap is based on a probabilistic analysis of investment requirements over the regulatory period. In VENCorp's view, a probabilistic approach implies that there is no defined investment plan that identifies specific projects. If this view is correct, VENCorp is concerned that the absence of a defined plan will make it very difficult for the ACCC to assess a TNSP's performance at the next revenue cap review. In particular, it will be difficult to ascertain whether any underspend is efficient, or whether projects have been inefficiently deferred.

- VENCorp also notes that the ACCC's information requirements[2] for revenue applications appears to suggest that detailed project-based information is required. The ACCC's information requirements appear to contradict the "probabilistic approach" described in the *Draft Decision*, which would not provide project-specific information. In particular, the ACCC states that[3]:

> "In contrast to an ex-post capex regime, an ex-ante regime places greater emphasis on conducting a rigorous review of forecast investment before the investment is undertaken. This increases the information required in a TNSP's revenue cap application (see Chapter 5 of the Background Paper)."
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> "In relation to each forecast project, the TNSP should provide:
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> (i) a detailed description of the project
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> (ii) the regulatory test application (if one has been conducted)
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> (iii) details on why the project is required
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> (iv) the timing and costs of the project (and how these were derived)
>
> (v) details on the options considered in addition to the preferred option (including the estimated cost of the alternative options considered)

1 ACCC, *Draft Decision*, page 17.

2 ACCC, *Draft Decision*, page 30.

3 ACCC, Draft Decision, page 30.

(vi) the methodology and analysis used to select the preferred option."

- In VENCorp's view, the *Draft Decision* lacks clarity on the extent of information required to establish the ex ante cap. VENCorp is particularly concerned that the ACCC's approach to setting the ex ante cap appears to be de-coupled from the regulatory test. It is not clear what role, if any, the regulatory test will play in setting the ex ante cap. VENCorp questions why the regulatory test appears to be given less weight in setting the ex ante cap, compared to the current ex post approach to capital expenditure[4].

- In VENCorp's view, for assets to be included in the RAB, the TNSP should demonstrate that the regulatory test has been undertaken, and the justified project has been undertaken. We also suggest that amount rolled in for a project should be capped by the project cost justified in the regulatory test. Such arrangements would ensure an appropriate alignment of the requirements of the regulatory test, as well as providing incentives for TNSPs to execute economically justified investments in an efficient manner.

- VENCorp is also concerned that the ACCC does not appear to have fully considered the risk of *uneconomic* deferral of investment. The *Background Paper* states that[5]:

  > "An ex ante cap provides an incentive for TNSPs to find ways to defer expenditure. This is an efficient outcome since it means that the TNSP uses less input to deliver the same output (assuming of course that deferring expenditure did not lead to a reduction in service quality). Under the proposed ex ante incentive, TNSPs would capture all of the value of this incentive, until the next regulatory reset at which point consumers would benefit through a relatively lower RAB.

  VENCorp considers that deferral is *uneconomic* if it is not consistent with good engineering practice. It is feasible that a TNSP could defer capital expenditure uneconomically (for commercial gain) without affecting service performance in the short-term. In our view, the ACCC appear to be either understating or ignoring the possibility of uneconomic deferral of investment, on the basis that service standards schemes are in place which will influence investment decisions. However, we question whether the service standard schemes[6] have any ability to safeguard against uneconomic deferral of capital expenditure, as the impact of transmission deferrals are not seen for a considerable time (and most likely not within the timeframe of a regulatory period).

  Moreover, it is also possible that in response to the incentives created by the ACCC's proposed arrangements, TNSPs may succeed in having a provision for the same capital expenditure included in two or more successive revenue cap determinations. All else held constant, this would result in a net increase in total costs borne by consumers, because the TNSP's allowed revenue would recover the annualised cost of the asset for the period over which the capital expenditure is deferred, as well as for the entire life of the asset once it is installed.

  These issues require further careful consideration by the ACCC.

In relation to excluded projects:

- VENCorp agrees with the ACCC that projects excluded from the ex ante cap must be linked to unique investment drivers – such as a major point load or expected power station – rather than to general investment drivers (such as expectations of load growth within a region). In VENCorp's view, there should be no exclusions for any asset replacement works.

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4 ACCC, Draft Decision, page 33.

5 ACCC, *Background Paper*, page 81.

6 We refer to both the existing service standard schemes as set out in existing ACCC revenue cap decisions, and also the proposed market impact transparency measures as proposed by the ACCC.

- The amount included in the RAB for excluded projects should be set according to the cost estimates in the regulatory test. This would provide the TNSP with an incentive to deliver the project efficiently.

In relation to "off-ramp" mechanisms:

- VENCorp notes that an "off-ramps" event can be invoked by a TNSP, ACCC or third party. The *Draft Decision* states[7] that if the cost of the event during the period of a regulatory control exceeds 5% of the capex allowance for the regulatory period, this cost will be recoverable from consumers. The *Background Paper* also explains[8] that the off-ramp is intended to be symmetrical in that it could lead to a reduction in transmission revenue as well as an increase.

- Whilst we note that the mechanism is intended to be symmetrical, the language in the *Draft Decision* appears to focus predominantly on cost increases. For example, the off-ramp is said to apply[9]:

  > "…if unexpected events cause capital expenditure blow-outs during the regulatory period."

  In VENCorp's view, this language (and the suggestion that the 5% threshold only applies to cost increases) is likely to cause confusion regarding the intention of the off-ramp mechanism. VENCorp also questions whether the administrative process by which customers could seek an off-ramp event has been thoroughly considered. For example, how could customers ascertain whether an event would have an impact on a TNSP's capital expenditure plans and how could a TNSP guard against frivolous claims that an off-ramp event had occurred?

- In summary, VENCorp doubts whether the benefit of introducing an off-ramp mechanism is likely to outweigh the likely costs. VENCorp notes in particular that it may be difficult to isolate the cost impact of the off-ramp event.

4 OPERATING EXPENDITURE

VENCorp notes that the ACCC is not proposing any major changes in its approach to setting operating expenditure benchmarks, apart from the more formal establishment of an efficiency carry-over mechanism to encourage cost efficiencies.

VENCorp supports the ACCC's approach, and in particular welcomes improved clarity on how the efficiency carry-over mechanism is to apply. It is self-evident that efficiency mechanisms can only have a positive effect on behaviour if their application is fully understood by TNSPs. The *Draft Decision* is a step in the right direction in terms of providing greater clarity on this issue.

VENCorp also notes that the ACCC intends to more closely examine the use of benchmarking to set operating expenditure allowances in the future. It is important that the ACCC properly considers the likely value of this work before embarking on a major exercise. In VENCorp's view, benchmarking has clearly exposed limitations which arise from inherent and inherited differences between TNSPs. VENCorp would encourage the ACCC to explore experiences in other jurisdictions as an initial step in formulating the scope of further work on benchmarking.

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7 ACCC, *Draft Decision*, page 19.

8 ACCC, *Background Paper*, page 99.

9 ACCC, *Draft Decision*, page 17.

5 WACC

VENCorp supports the ACCC's approach to estimating the WACC. It is important, however, that the ACCC's assessment of WACC should take account of the TNSP's fairly limited exposure to stranded asset risk in the proposed regulatory framework.

6 SERVICE STANDARDS

In relation to service standards, VENCorp notes that the ACCC has embarked upon a separate process for determining the information it intends to publish about market impacts and transmission constraints. At this stage, the ACCC does not propose to set financial incentives on TNSPs. VENCorp supports the ACCC's proposal to publish information on the total and marginal constraint costs, as a first step.

In addition, VENCorp would wish to ensure that the availability incentive scheme agreed between SPI PowerNet and VENCorp can be accommodated within the ACCC's future revenue cap decisions, if the parties agreed to continue the scheme.

Finally, on a more general note, VENCorp believes that there remains scope for the ACCC's revenue cap determinations to provide a more clear linkage between:

- the services (and standards of service) that the TNSP is required to deliver; and
- the regulated revenue allowance that the TNSP is entitled to receive upon satisfactory delivery of those services.

At present, the service standards as defined in the regulatory regime do not adequately address this question.